TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, [redacted] 1962

No. [redacted] 72

WISCONSIN, ET AL., PETITIONERS,

vs.

FEDERAL POWER COMMISSION, ET AL.

No [redacted] 73

CALIFORNIA, ET AL., PETITIONERS,

vs.

FEDERAL POWER COMMISSION, ET AL.

No. [redacted] 74

LONG ISLAND LIGHTING CO., ET AL.,
PETITIONERS,

vs.

FEDERAL POWER COMMISSION, ET AL.

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

FILED FEBRUARY 28, 1962
CERTIORARI GRANTED MAY 14, 1962

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IN THE

United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 16,175

STATE OF WISCONSIN and PUBLIC SERVICE COMMISSION OF WISCONSIN, *Petitioners*

v.

FEDERAL POWER COMMISSION, *Respondent*

No. 16,177

LONG ISLAND LIGHTING COMPANY, PHILADELPHIA ELECTRIC COMPANY and THE UNITED GAS IMPROVEMENT COMPANY, *Petitioners*

v.

FEDERAL POWER COMMISSION, *Respondent*

No. 16,180

PEOPLE OF THE STATE OF CALIFORNIA and PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, *Petitioners*

v.

FEDERAL POWER COMMISSION, *Respondent*

On Petition to Review Order of the Federal Power Commission

JOINT APPENDIX

EXCERPTS FROM TRANSCRIPT OF PROCEEDINGS

6331

William H. Lyon

was called as a witness, and, having been first duly sworn, was examined and testified as follows:

6332

Direct Examination

By Mr. Lamb:

. . . . . .

6347

This does not however, mean that the BTU method is unsatisfactory as a cost denominator. It simply means that the relationship between costs and BTU's should be examined in more detail. It may be that with a proper adjustment multiplier for oil, the BTU approach will serve. Among the factors affecting such an adjustment are the following: The area that a gas well drains is many times that of an oil well. Differences in the optimum rate of production is a factor in this spacing, but reservoir performance is different in the case of each product.

In the case of Phillips, gas well spacing averages one well per 520 acres whereas oil well spacing averages one well per 20 acres. Next where the hydrocarbons are oil, the BTU content will be 3 to 5 times that where it is gas and this ratio changes with the gas pressure in the reservoir. Both reservoir content factors are modified by recovery factors with that of gas around 80 percent while that of oil is around 50.

Deeper reservoirs mean higher per well cost for either product, though we do not know yet to what extent this is offset by higher per well recoveries.

The net effect of these variables on relative production

costs will require some further study. Present indications are that if an overall adjustment factor can be developed to employ the BTU method, it will be to multiply the BTU's of oil by a

6348

factor of somewhere between 4 and 6 before allocating costs.

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7853

Dan L. Mayer

was called as a witness, being first duly sworn, was examined and testified as follows:

Direct Examination

By Mr. Heady:

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7876

Q. When you speak of casinghead gas contracts, are you referring to a particular contract, or to a type of contract which is in general use? A. I am referring to a form or type of contract which is adapted to fit the needs of a situation peculiar to casinghead gas. The term "casinghead gas contract" is a term which is generally understood in the industry, and denotes the general type of provisions contained in the contract as distinguished from the specific provisions.

The most outstanding feature of the casinghead gas contract is that it does not provide a specific price per Mcf.

Q. What are the conditions under which the casinghead gas type of contract is used and what in general is the nature of the provisions in such contracts. A. The casinghead gas contract is a type of contract

which was developed over a period of years in the industry to meet the particular necessities of handling casinghead gas. It is essentially an agreement whereby the producer participates in the proceeds received by the gasoline plant operator who is the purchaser, rather than an agreement by the purchaser to pay a specified amount per Mcf. The gasoline plant operator agrees to pay an amount for the gas which is the sum of two calculations. One calculation is based on the test gasoline content contained in the gas, the amount so determined being related to both the quantity of test gasoline in the gas, and the current market price of natural gasoline and other liquids extracted.

The other calculation is a percentage of the proceeds received by the gasoline plant operator from such portion of the residue gas as the plant operator has available, and is able to sell.

The various forms of casinghead gas contracts in actual use will differ in their specific provisions, and in their methods of computation, but in general the different forms of casinghead gas contract are merely variations of the two computations based on test gasoline content and residue proceeds.

Q. What percentage of the proceeds from the sales of residue gas by the gasoline plant operator is paid to the producer? A. That percentage will vary among the different forms of casinghead gas contract, but it usually runs between 50 and

75 percent. Two forms of contract developed by the Natural Gasoline Association of America provide for 50 percent of the proceeds. These particular forms are in such common use that printed forms can be purchased

from almost any printing establishment operating in a producing area.

The form of contract generally used by Phillips provides for payment to the producer of 50 percent of the first 2.6798 cents per Mcf received and 66⅔ percent of all above that. This averages something in excess of 60 percent of the residue proceeds received by Phillips. If there are any added costs of handling the residue gas, as for boosting, treating or dehydrating, the casinghead gas contracts usually provide for a deduction of those costs before applying the stated percentage to the proceeds.

Q. Is there any particular reason for the participating features of these contracts? A. Yes, the participating character of these contracts is an essential to the purchase and sale of casinghead gas, because casinghead gas is produced with oil and controlled by the amount of oil production it is subject to fluctuation in volumes of production. This is contrasted with production from a gas field, which is controlled by market demand for gas.

Another important factor is that the producer may need all or substantially all of the residue gas for his lease operations. This need of the producer for the return of the residue gas has

7879

always been recognized in the contracts, themselves, which provide that the producer may have all or any part of the residue returned for lease operation, if he wants it. Each of these conditions make it difficult for the gasoline plant operator to know how much residue gas he will have available for sale, yet to meet the needs of the producers, the gasoline plant operator has to agree to take the casinghead gas and process it.

7880

One of the most variable factors affecting the value

of and, therefore, the price paid for casinghead gas is the gasoline content. This varies from field to field, and from well to well within the same field, and is dependent upon many things, including gas-oil ratio, temperature and separation pressure. Respecting the effect of temperature, considerable seasonable variation is experienced. For this reason, content tests are usually conducted quarterly.

An inspection of a summary of all casinghead gas contract content tests for Phillips' plants shows a range from .158 gallons per thousand cubic feet to 13.6 gallons per thousand cubic feet.

Because of all of these variable factors, the participating features of these contracts were developed whereby the plant operator agrees that he will pay an amount based on the gasoline content, and, if there is any residue left which the producers do not want returned and the plant operator is able to sell it, a percentage of what the plant operator gets for it.

This type of contract has worked very satisfactorily for over 25 years.

Q. In your opinion, would it be practical for a producer such as Phillips to charge specific rates for sales of gas to gasoline plants which are now being made under the casinghead gas type of contract? A. In my opinion, it would not be practical to do so. As

I have stated, the casinghead gas contract was originally developed to meet the needs of a peculiar situation. The fact that casinghead gas sales may now be subject to regulation does not eliminate the practical considerations which brought about the use of casinghead gas contracts in the first place. I do not believe that specific rates for casinghead gas could be used with any degree of success.

Q. Do you believe that it would be practical to charge a specific rate applicable to that portion of the residue gas which remains after processing, and return to leases and is available for sale by the purchaser? A. No.

Q. Why do you reach that conclusion? A. The purchaser under the casinghead gas contract agrees to purchase all of the gas, whether or not he has a market for all of the residue. Since the volumes of residue gas available for sale vary both with the production of raw gas and with the amount returned to leases, the purchaser might be forced into paying for gas for which he had no market.

The changes in the volume of residue gas available for sale and the volumes which can be sold can change abruptly, without notice, and the gasoline plant operator would assume an unjust and uneconomic burden if he were forced to pay a specific price for gas, for all residue gas available for sale.

* * * * * * * * * * *

8445

Lloyd Cramer

was called, and having been previously duly sworn, was

8446

examined and testified further as follows:

Further Direct Examination

By Mr. Heady:

* * * * * * * * * * *

8486

Q. I notice that in both your Exhibits 282 and 283, you have used costs and revenues as of January 1, 1956, whereas Exhibit 223, prepared by Mr. Mayer, includes revenues under rates proposed by Phillips as of November 1, 1956.

Can you reconcile the cost and revenue figures which you have used with the higher revenues shown by Mr. Mayer? A. Yes, Exhibits 282 and 283 were first—since Exhibits 282 and 283 were first prepared, the Commission has at various times ordered the rate increases proposed by Phillips to Panhandle Eastern Pipeline Company in docket Nos. G-10883 and G-11125, to Michigan-Wisconsin Pipeline Company in Docket No. G-10793, and to El Paso Natural Gas Company in Docket G-11217 to be consolidated with this proceeding. It was not possible within the time that was available to revise these exhibits—that is Exhibit 282 and Exhibit 283, to show the effect of the additional increases proposed by Phillips.

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13558

Edward L. Dunn

resumed the stand and, having been previously duly sworn, was examined and testified as follows:

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13573

Further Cross-Examination

By Mr. Heady:

Q. Mr. Dunn, you referred, as I recall, to the fact that in El Paso's recent rate filing, it anticipated the contractual increases which were to become effective January 1, 1958, and included that as a part of its costs in the rate filing. Is that correct? A. That is correct.

Q. In any rate filing made by El Paso, did El Paso ever include the effect of the contractual increase to Phillips so that if El Paso got the rates which it had filed for, those rates would then include the increase to Phillips, and there would be no need for any further change in El Paso's rates? A. In one filing, it did. That

was Docket G-2018, because, as you will recall, there was an agreement reached as to what the rate would be under that docket. That was included in the filing in Docket G-2018.

13574

Q. That is the only time it ever was done? A. The next filing, Docket G-4769, it was not done.

Q. You would agree mathematically it could be done, so that when the Commission grants the rate to El Paso there would be no further change in El Paso's rates? A. I would agree that, mathematically, it could be done. As to what the effect would be with respect to further changes in El Paso's rates for other factors, that would be another matter.

Mr. Heady: That is all I have.

Mr. Lamb: Mr. Examiner, I have another question as a result of that.

Further Cross-Examination

By Mr. Lamb:

Q. You said mathematically it could be done, Mr. Dunn. Well, just how, in actuality, could it be done? Could you come to the Commission representing El Paso and say, "Well, if we get a rate increase, it is going to have to include something that we haven't paid out yet, but contractually we may have to pay out next year." Is that the way it would be presented to the Commission? A. Yes. And that is done many times, sir.

As a matter of fact, that is the way Pandhandle Eastern files.

Q. Well, how was this agreement made that you referred

13575

to when you answered Mr. Heady's question? You said some agreement was made in what, 2018, Docket G-2018? A. Yes.

(13575)

Q. Who was the agreement made by? A. Mr. Paul Kayser, with Phillips.

Q. And it was presented to the Commission on that basis?

13576

A. Yes.

Q. And how was it handled then, do you know? A. Well, the Commission allowed it.

* * * * * * * * * * *

16984

Oral Argument

* * * * * * * * * * *

Mr. Torkelson: [Counsel for Wisconsin] Now, we finally, in the limited time available, we do want to make a brief comment about this matter of system-wide versus area rates.

In this case, as the Commission is aware, we made a motion for the purpose of obtaining additional evidence on this subject, namely, so that there would be an additional-- I am sorry.

Mr. Reese: Mr. Chairman, if it would be possible, I would be happy to yield enough time to Mr. Torkelson to finish that point, if he wanted to.

The Chairman: All right. You have ten minutes, do you?

16985

Mr. Reese: Yes, sir.

The Chairman: Go ahead, Mr. Torkelson.

Mr. Torkelson: I will take five minutes of it.

This motion together with a similar staff motion was made for the purpose of obtaining additional evidence for the record to show costs in the various areas for the purpose of attempting to have rate making rather than on a system-wide basis, possibly on a location or area basis, and I am using the term "location" or "area" in a very general way.

Those motions, of course, were denied.

And on the basis of the record as made in this case there was, of course, the problem for the Examiner as to what to do under the circumstances. Phillips urged and the Examiner adopted the so-called system-wide or postage stamp approach and under the record, while we do not agree in principle that that is correct, still for purposes of this case, if this Commission wishes to apply this so-called postage stamp principle, based on the actual cost of service, that on the basis of that record we would not object and we feel that this is a possible solution to this problem.

Another possible solution is to adopt the cost of service and then order Phillips to file within a reasonable time tariffs or rates to return to it revenues which would cover that cost of service in the amount indicated.

Now, this is a method that is followed quite commonly by

regulatory Commissions. We understand that it was followed in Natural Gas Pipeline Company of America case decided back sometime about 1940 and, of course, is a method that your Wisconsin Commission frequently follows in prescribing rates.

Commissioner Connole: Would that be suited for independent producer situations, Mr. Torkelson?

Mr. Torkelson: We think it could be. We recognize there is a certain amount of flexibility there, but we think it could be worked out, and I am merely stating some broad principles.

Commissioner Connole: What would they properly do, file a rate, for example, for gas in the XYZ field or the ABC area and that would be the price for gas, just the way a transportation company files upstairs here, a rate for transportation of apples between Madison and Chicago. Is that the idea?

(16986)

Mr. Torkelson: Well, they would file a rate, but it would be a little bit different, I believe, because as we see it, that rate, together with other rates, would produce in the aggregate revenues which would equal a cost of service for Phillips.

Commissioner Connole: Even applicable then to future sales, future contracts not yet entered into?

Mr. Torkelson: Well, on that, which is a question that was raised this morning, our suggestion—and it is again on a very broad basis—would be that if the new sales should be in a location which would be, one might say reasonable within

16987

the scope of the existing area where they are doing business and making sales, then our thought was that it is possible to apply that rate to the future sales. On the other hand, if you should have sales or deliveries made in an entirely new area, remote, divorced, or for some other reason, then there probably would have to be a filing of some kind or a prescription of a rate in the light of that particular circumstance. I think that—

Commissioner Connole: Have you given any real serious thought as to whether that is the way to price natural gas or whether you should continue on a contract-by-contract basis?

Mr. Torkelson: I can't claim to be an expert on this and I wouldn't want to be understood to be an expert, because I think that we are getting into the field where rate people should be consulted rather than—

Commissioner Connole: Rather than lawyers?

Mr. Torkelson: Yes, sir. Thank you very much.

Commissioner Connole: Mr. Torkelson, I guess it just follows from the whole approach you take that we should then regulate each and every producer in the same manner as you are advocating for Phillips?

Mr. Torkelson: That is a broad question, Your Honor. In principle I believe that is true, but I also believe and I think we have indicated in certain length [circumstances] that we would not

16988

object in principle to certain small producers which involve small volumes of gas having a different treatment.

When this Commission had the general investigation of how to fix producer rates sometime ago—and I do forget the docket number, but I am sure everybody recalls it—I think we made that proposal. We indicated that there might be a different treatment for what we might call a smaller producer.

Commissioner Stueck: But supposing you had three big producers operating on a unitized basis and each one having a different cost of service? Would you reconcile yourself to charging three different prices for the same gas coming out of the same hole?

Mr. Torkelson: I believe this Commission has faced up to that situation in certain cases and—

Commissioner Stueck: That would be a variation, of course, from your theory?

Mr. Torkelson: Not necessarily.

Thank you very much.

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(18622)

[18425 on facing page]

18622

Exhibit No. 282

CRAMER 2/15/57

PHILLIPS PETROLEUM COMPANY AND SUBSIDIARY COMPANIES
JURISDICTIONAL NATURAL GAS OPERATIONS

Pro Forma Statement of Cost of Service and Deficiency in Earnings
Based on Year 1954

	Amount	MCF Volume	Per MCF
	(a)	(b)	(c)
Cost of service-jurisdictional sales from systems	$68,568,876.42		
Cost of service-jurisdictional sales from leases	13,094,498.59		
Sub-total	81,663,375.01		
Regulatory commission expense	400,000.00		
Total cost of service-jurisdictional sales of gas	82,063,375.01		16.707¢
Revenue from jurisdictional sales	45,568,291.02		9.277¢
Deficiency in earnings	36,495,083.99		7.430¢
Total jurisdictional sales—MCF @ 14.65 psia		491,178,953	

Docket G1148 et al
Exhibit
Page 1

18425

Exhibit No. 215-A

PHILLIPS PETROLEUM COMPANY DOCKET NO. G-1148
Indicated Rates Compared With Book Revenues, Present Rates and Cost
All Areas

No. Line	Particulars	1954 Sales Volumes MCF @ 14.65#	1954 Revenues Per Books		Revenues on 1954 Sales Volumes at July 1, 1956 Rates		1954 Allocated Cost of Service		Revenues on 1954 Sales Volumes at Indicated Rates		Increase (Decrease) of Revenues Under Indicated Rates Over			Remarks
			Amount	Avg. Rate	Amount	Avg. 7-1-56 Rates	Amount	Avg. Cost	Amount	Cents/ MCF	Per Books	7-1-56 Rates	Cost	
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)
	Panhandle Areas													
1	Wellhead Sales—Dry Gas	10151656	$ 323793	3.19¢	$ 401667	3.957¢	$ 890595	8.7729¢	$ 886158	8.73¢	$562365	$ 484491	$(4437)	
2	Wellhead Sales—Csghd. Gas—Specific	197051	8434	4.28	8921	4.527	17287	8.7729	16763	8.51	8329	7842	(524)	
3	Gathering System Sales	13556716	1873314	13.82	1885365	13.907	1506843	11.1151	1490769	11.00	(382545)	(394596)	(16074)	
4	Residue System Sales	280541682	25596542	9.12	27472962	9.793	26230928	9.3501	26273869	9.37	677327	(1199093)	42941	
5	Total	304447105	27802083	9.13	29768915	9.778	28645653	9.4091	28667559	9.42	865476	(1101356)	21906	
	Permian Basin Area													
6	Residue System Sales	111778499	8460752	7.57	8679344	7.765	9410744	8.4191	9389394	8.40	928642	710050	(21350)	
	Miscellaneous													
7	Wellhead Sales—Dry Gas	13721169	1285508	9.37	1366534	9.959	5037987	36.7169	5037987	36.72	3752479	3671453	0	
8	Wellhead Sales—Csghd. Gas—Specific	14842126	1331572	8.97	1697916	11.440	1302084	8.7729	1298686	8.75	(32886)	(399230)	(3398)	
9	Wellhead Sales—Csghd. Gas—Percentage	12588114	692166	5.50	692166	5.499	927945	7.3716	944110	7.50	251944	251944	16165	
10	Residue System Sales	24968617	2533380	10.15	2659805	10.653	2096838	8.3979	2099722	8.41	(433658)	(560083)	2884	
11	Total	66120026	5842626	8.84	6416421	9.704	9364854	14.1634	9380505	14.19	3537879	2964084	15651	
12	Total All Areas	482345630	$42105461	8.73¢	$44864680	9.301¢	$47421251	9.8314¢	$47437458	9.83¢	$5331997	$2572778	$ 16207	

26148

Docketed Oct. 28, 1948

100-2 Formal

Docket No. G-1148

Order Instituting Investigation

Upon consideration of the Commission's official files and the public records of other federal agencies pertaining to Phillips Petroleum Company (hereinafter referred to as "Respondent"), a Delaware corporation with principal executive offices at 80 Broadway, New York 5, New York, and Phillips Building, Bartlesville, Oklahoma;

It appears to the Commission that:

(a) Respondent is engaged, among other things, in the production, purchase, gathering, transportation and sale of natural gas in the State of Arkansas, Kansas, New Mexico, Oklahoma, and Texas;

(b) Respondent reports that it owns and operates approximately 3,800 miles of gathering, residue, and other gas lines located in the States designated above, together with various compressor or booster stations and appurtenant facilities;

(c) In this Commission's Opinion In the Matter of Michigan-Wisconsin Pipe Line Company, January 17, 1947, 6 F.P.C. 1, 67 P.U.R. (N.S.) 427, we stated therein with respect to the motion filed by the City of Detroit on October 11, 1946, for an order requiring Respondent herein to be made a party to the proceeding in Docket No. G-669:

"We believe that whether Phillips is or is not a natural gas company cannot properly be determined in this proceeding. If such determination is required it should be made a separate case after a thorough investigation of Phillips' operations and we therefore find that the motion of the City of Detroit should be dismissed."

(d) By its letters of June 19, August 15, September 6, 1940, April 3, 1941, and August 3, 1943, to this Commission, Respondent has disclosed that it is or will be a natural-gas company within the meaning of that term as used in the Natural Gas Act;

(e) In 1947, Respondent reported to the Securities and Exchange Commission, with respect to its sale of natural gas to purchasers which transport and sell the gas in interstate commerce, that "Although such sales and the transportation of natural gas antecedent thereto constitute operations by the Company as a 'natural gas company' under the Natural Gas Act, and, as such, are subject to the Federal Power Commission's jurisdiction, unless the exercise of such jurisdiction constitutes an interference with state regulation of production and gathering, the Commission with Commissioner Draper dissenting in a a declaration made on the 15th day of August, 1947, disclaimed the intention to exercise jurisdiction over such sales if made at arm's length, that is, sales made as an incident to the producing or gathering operation by a producer or gatherer of gas to a non-affiliate (Order No. 139, Docket No. R-106)";

(f) By reason of its operations, facilities, and sales of natural gas to purchasers which transport and resell

such gas in interstate commerce for ultimate public consumption, Respondent may be a natural-gas company subject to the jurisdiction of the Commission;

The Commission finds that:

It is necessary and proper, in the public interest, that an investigation be instituted by the Commission, upon its own motion:

(1) To determine whether Respondent is a natural-gas company within the meaning of the Natural Gas Act; and

(2) Into and concerning all rates, charges, or classifications demanded, observed, charged or collected by Respondent in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, and any rules, regulations, practices, or contracts affecting such rates, charges, or classifications;

The Commission, upon its own motion, orders that:

An investigation of Respondent, Phillips Petroleum Company, be and hereby is instituted for the purpose of enabling the Commission:

(A) To determine with respect to the Respondent:

(i) Whether it is a natural-gas company within the meaning of the Natural Gas Act; and

26150

(ii) Whether, in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, any rates, charges, or classifications demanded, observed, charged, or collected, or any rules, regulations, practices or contracts affecting such rates, charges, or classifica-

tions are unjust, unreasonable, unduly discriminatory, or preferential; and

(B) If it shall find, after hearing, that the Respondent is a natural-gas company within the meaning of the Natural Gas Act, and that any of Respondent's rates, charges, classifications, rules, regulations, practices, or contracts, subject to the jurisdiction of the Commission, are unjust, unreasonable, unduly discriminatory, or preferential, to determine and fix by order or orders just and reasonable, nondiscriminatory or non-preferential rates, charges, classifications, rules, regulations, practices, or contracts to be thereafter observed and in force.

By the Commission.

Date of Issuance: October 29, 1948

* * * * * * * * * * *

32909, 32911, 32919

[Extract from opinion of May 22, 1953 in No. 11,247—USCA-DC, *State of Wisconsin and Public Service Commission of Wisconsin* v. *Federal Power Commission,* is printed at pages 405 to 406 of this Joint Appendix.]

32929

[Judgment and Decree of May 22nd, 1953 in above-captioned case is printed at page 406 of this Joint Appendix.]

32931-32932

[Commission Order Vacating Termination of Proceedings and Continuing Investigation issued November 22, 1954 is printed at pages 407 to 409 of this Joint Appendix.]

30467

Docket No. G-1148

Docket Nos. G-3175, G-4333, G-6621, G-7773, G-8623, G-8695, G-8883 and G-10359

Order Consolidating Proceedings and Fixing Date of Hearing

(Issued May 28, 1956)

By order issued October 29, 1948, in Docket No. G-1148, the Commission instituted an investigation of Phillips Petroleum Company (Phillips) to determine (1) whether it is a natural-gas company within the meaning of the Natural Gas Act, and (2) whether, in connection with any transportation or sale of natural gas by such company, subject to the jurisdiction of the Commission, any rates, charges, or classifications demanded, observed, charged or collected, or any rules, regulations, practices or contracts affecting such rates, charges, or classifications are unjust, unreasonable, unduly discriminatory, or preferential.

In its opinion issued August 22, 1951,[1] the Commission found, inter alia, that Phillips was not a natural-gas company within the meaning of Sections 1(b) or 2(6) of the Natural Gas Act, and by order accompanying that opinion the Commission terminated the investigation proceeding instituted by its order of October 29, 1948. Thereafter, the United States Court of Appeals for the District of Columbia Circuit handed down its opinion[2] reversing the Commission and determined that Phillips is a natural-gas company

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[1] In the Matter of Phillips Petroleum Company, Docket No. G-1148, Opinion No. 217 and accompanying order, 10 F.P.C. 246, 283.

[2] *State of Wisconsin* v. *Federal Power Commission*, 92 U.S. App. D.C. 284, 205 F. 2d 706.

and that the "Commission should fix the rates" for the Phillips

sales of natural gas for resale in interstate commerce. On June 7, 1954, the United States Supreme Court affirmed the opinion of the Court of Appeals.[3]

In compliance with the mandate of the Court of Appeals, the Commission, on November 22, 1954, issued its Order Vacating Termination of Proceedings and Continuing Investigation in Docket No. G-1148.

In each of the eight other dockets hereinabove designated,[4] the Commission has heretofore issued its order suspending proposed increases in rates and charges for sales of natural gas for resale in interstate commerce by Phillips. Such proposed increases approximate $2,300,000 per year in the aggregate. The sales and deliveries of gas involved in the eight designated suspension dockets are made by Phillips to Michigan-Wisconsin Pipe Line Company, Northern Natural Gas Company, Cities Service Gas Company, Arkansas-Louisiana Gas Company, El Paso Natural Gas Company, Consolidated Gas Utilities Corporation, Transcontinental Gas Pipe Corporation and Mississippi River Fuel Corporation. Such sales and deliveries of gas by Phillips involve questions of law and fact interrelated with those inherent in the matters involved and the issues presented in Docket No. G-1148.

The Commission finds:

It is appropriate and in the public interest in carrying out the provisions of the Natural Gas Act and good

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[3] *Phillips Petroleum Company* v. *Wisconsin, et al.*, 347 U.S. 672.

[4] Docket Nos. G-3175, G-4333, G-6621, G-7773, G-8623, G-8695, G-8883 and G-10359.

cause exists to consolidate the above-entitled proceedings for the purpose of hearing.

The Commission orders:

(A) Pursuant to the authority contained in and subject to the jurisdiction conferred upon the Federal Power Commission by the Natural Gas Act, including particularly Sections 4, 5, 14, 15, and 16 thereof, and the Commission's General Rules and Regulations (18 CFR Chapter I), the proceedings in the above-designated Docket Nos. G-1148, G-3175, G-4333, G-6621, G-7773, G-8623, G-8695, G-8883 and G-10359 be and the same hereby are consolidated for the purpose of hearing.

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(B) A hearing be held commencing on June 26, 1956, at 10:00 a.m.(EDST) in a Hearing Room of the Federal Power Commission, 441 G St., N. W., Washington, D. C., concerning the matters involved and the issues presented in the consolidated proceedings designated in paragraph (A) above.

(C) Interested State commissions may participate as provided by Sections 1.8 and 1.37 of the Commission's Rules of Practice and Procedure. [18 CFR 1.8 and 1.37 (f)].

By the Commission.

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30924

Docket Nos. G-1148 et al. and G-11217

Petition to Intervene by California Public Utilities Commission and People of California

Through the attorney for the Public Utilities Commission of the State of California, the people of the State of California and said Public Utilities Commission respectfully petition that they be authorized by appropriate order to intervene in these proceedings. This petition is filed pursuant to § 1.8 of the Commission's Rules of Practice and Procedure.

The attorney for the California Public Utilities Commission is empowered to "represent and appear for the people of the State of California" in proceedings of this character. Calif. Public Util. Code, Sec. 307.

I.

It is understood and believed and therefore alleged that Phillips Petroleum Company sells a significant amount of gas to El Paso Natural Gas Company, that in turn a significant amount of the gas which El Paso sells to public utility gas companies operating within California is derived from such gas furnished by

30925

Phillips, that in consequence the charges for gas by Phillips may affect the charges for gas by El Paso and in turn the charges for gas by public utility gas companies operating within California.

II.

The California Public Utilities Commission is empowered by constitution and statute to regulate the rates of public utility gas companies operating within California. Cal. Const., Art. XII, Secs. 22, 23; Calif. Public Util. Code

(Stats, 1951, ch. 764, as amended). Its interest in proceedings of this character is therefore derived from the responsibilities entrusted to it.

III.

In Docket No. G-11217, Phillips proposed originally an annual increase of $1,813,000 in rates for sales of gas to El Paso. At the most recent hearings in the consolidated proceedings herein, it was revealed that Phillips now proposes an increase of some $18,000,000 per annum in charges to El Paso. The magnitude of this new proposal and its serious potential impact upon utilities and consumers in California impels the California Public Utilities Commission to request authority to intervene herein. Being entrusted with the fixing of reasonable rates for gas service throughout California, the California Commission is the only entity which can adequately represent the public interest of all the California consumers which might be affected by Phillips' proposal.

IV.

An additional ground for seeking intervention herein is that the pleading recently filed by El Paso answering Phillips' motion to place into effect proposed rate changes and moving for dismissal of Docket No. G-11217, raises serious and important questions respecting "spiral escalation clauses" and the applicability of *United Gas Pipe Line Co. v. Mobile Gas Service Corp.*, 350 U.S. 332.

V.

It is respectfully urged 1) that the right and interest of the California Public Utilities Commission in these proceedings is clear, 2) that no other entity is adequately

able to represent the public interest herein as it affects California customers and California utilities, 3) and that intervention at this juncture is necessary and appropriate in the light of Phillips' recent proposal and the issues raised by El Paso's recent pleading aforementioned.

WHEREFORE, it is respectfully petitioned that intervention be authorized.

Respectfully submitted,

THE PEOPLE OF THE STATE OF CALIFORNIA AND THE PUBLIC UTILITIES COMMISSION OF SAID STATE

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San Francisco, California

30999

Docket Nos. G-1148, G-3175, G-4333, G-6621, G-7773, G-8623, G-8695, G-8883, G-10,359, G-10,793, G-10,883, G-11,125 and G-11,217

Order Denying Request for Limited Hearing and Permitting Increased Rates to Go Into Effect Subject to Refund

(Issued April 26, 1957)

On September 10, 1956, Phillips Petroleum Company (Phillips) tendered for filing proposed increases in rates for sales of natural gas to El Paso Natural Gas Company (El Paso) as follows:

Description	Purchaser	Rate Schedule Designation	Effective Date
Notice of change	El Paso Natural Gas Company	Supplement No. 19 to Phillips' FPC Gas Rate Schedule No. 32	October 11, 1956
Notice of change	El Paso Natural Gas Company	Supplement No. 6 to Phillips' FPC Gas Rate Schedule No. 234	October 11, 1956
Notice of change	El Paso Natural Gas Company	Supplement No. 8 to Phillips' FPC Gas Rate Schedule No. 64	October 11, 1956
Notice of change	El Paso Natural Gas Company	Supplement No. 5 to Phillips' FPC Gas Rate Schedule No. 7	October 11, 1956
Notice of change	El Paso Natural Gas Company	Supplement No. 11 to Phillips' FPC Gas Rate Schedule No. 9	October 11, 1956
Notice of change	El Paso Natural Gas Company	Supplement No. 8 to Phillips' FPC Gas Rate Schedule No. 33	October 11, 1956

(31000)

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Pursuant to an order issued on October 10, 1956, the Commission directed that a hearing be held concerning the lawfulness of the rates, charges, classifications, and services contained in Phillips' above-designated rate filings and suspended the filings for the statutory five-month period until March 11, 1957. The proceeding instituted for the purpose of determining the lawfulness of the increased rates and charges embodied in the above-designated rate filings has not been concluded, nor has a decision been rendered therein.

On October 17, 1956, Phillips filed an application for rehearing of the Commission's suspension order. This application was denied by order issued November 9, 1956. Thereafter, on November 26, 1956, Phillips filed a motion for consolidation of the proceeding in docket No. G-11,217 with the proceedings in docket Nos. G-1148, et al., which consolidation was subsequently made. On January 3, 1957, Phillips filed a petition and motion for shortening the suspension period from March 11 to January 3, 1957, and making the suspended rates effective on the latter date. Finally, on March 8, 1957, Phillips filed a motion to place the suspended rates in effect on March 11, 1957, at the end of the five-month suspension period. This motion is now pending action by the Commission.

Section 4(e) of the Natural Gas Act provides that whenever a new rate schedule is filed, the Commission shall have authority to enter upon a hearing concerning the lawfulness of the same; and that pending such hearing and the decision thereon, the Commission may suspend the operation of the new rate schedule, "but not for a longer period than five months beyond the time when it would otherwise go into effect."

Said section further provides:

> "If the proceeding has not been concluded and an order made at the expiration of the suspension period, on motion of the natural-gas company making the filing, the proposed change of rate, charge, classification, or service shall go into effect. Where increased rates or charges are thus made effective, the Commission may, by order, require the natural-gas company to furnish a bond, to be approved by the Commission, to refund any amounts ordered by the Commission; to keep accurate accounts in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts were paid, and upon completion of the hearing and decision, to order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified."

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El Paso's filings in docket No. G-11,217 are almost as numerous as those of Phillips and beginning with its petition to intervene filed on September 18, 1956, El Paso has consistently opposed Phillips' proposed rate increases. In its said petition El Paso contends, *inter alia*, that certain of the pricing provisions contained in the contracts between itself and Phillips are "contrary to public policy."

On January 16, 1957, El Paso filed an answer to Phillips' petition for shortening of the suspension period wherein, after reviewing the pricing provisions of its rate schedules with Phillips, El Paso states: ". . . it is the position of El Paso that the gas purchase contracts which it has with Phillips do not provide any contractual basis for Phillips to file for the rate increases which it alleges it is entitled to receive from El Paso."

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On March 12, 1957, El Paso filed a tripartite pleading designated "Answer of El Paso Natural Gas Company to Motion of Phillips Petroleum Company to place into effect proposed changes in Rate Schedules; Motion by El Paso Natural Gas Company to dismiss Docket No. G-11,217, and; Request by El Paso Natural Gas Company for an early limited hearing on the issues here presented." In this pleading El Paso reiterates its contention that Phillips' proposed rate increases are void and of no legal effect because they are based upon spiral escalation provisions which are contrary to public policy. Further, El Paso contends that the operation of the spiral escalation provisions of the subject rate schedules have been suspended and are inoperative because of specific condition precedent to the filing of such increases has not been fulfilled. El Paso alleges that in such circumstances Phillips' increased rate filings are illegal and unauthorized under the rate schedules and constitute prohibited unilateral rate filings within the holding of the Supreme Court of the United States in the *Mobile* case[1] and consequently should be rejected and the proceeding in docket No. G-11,217, should be terminated.

Phillips, in its replies filed on January 25, March 27, and April 1, 1957, to El Paso's above-described pleadings, contends in substance that the condition precedent to its filing for increased rates under its rate schedule with El Paso has been satisfied; that the said filings are in accordance with the pricing provisions of the rate schedules; and that the increased rates should be made effective, subject to refund of excess charges, as of March 11, 1957.

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The records of the Commission disclose that, in addition to its above-designated sales of gas to El Paso, Phillips

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[1] *United Gas Pipe Line Company* v. *Mobile Gas Service Corporation*, 350 U.S. 432.

also sells gas to Panhandle Eastern Pipe Line Company (Panhandle) and to Michigan-Wisconsin Pipe Line Company (Michigan-Wisconsin) under rate schedules on file with the Commission, which schedules contain spiral escalation provisions similar to those complained of by El Paso as being "contrary to public policy." Increased rates filed by Phillips pursuant to such spiral escalation provisions have been suspended by the Commission, pursuant to Section 4 (e) of the Natural Gas Act, in the proceeding in docket No. G-10,793, a sale to Michigan-Wisconsin, and in the proceeding in docket No. G-10,883, a sale to Panhandle. Since both these proceedings, as well as the proceeding in docket No. G-11,217, have heretofore been consolidated for the purpose of hearing, with the proceedings in docket Nos. G-1148, *et al.*,[2] it is deemed appropriate and in the public interest that the legality of Phillips' rate filings in these three dockets be considered in the consolidated proceedings.

On March 15, 1957, Phillips tendered for filing an additional proposed rate increase for sales of natural gas under Phillips' FPC Gas Rate Schedule No. 4 to Michigan-Wisconsin. This proposed increase is based upon certain spiral escalation provisions in Phillips' said rate schedule which provide, in substance, that Phillips shall receive a proportionate increase in its rate for sale of gas to Michigan-Wisconsin when the latter company places in effect an increase in its wholesale rate for gas. By order issued in docket No. G-12,292 on March 28, 1957, the Commission suspended Michigan-Wisconsin's proposed increase in its wholesale rates, which increase was proposed to become effective on April 15, 1957, until September 15, 1957. Thus, although Phillips' related rate increase filing was timely filed on March 15, 1957, it cannot now, under the

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[2] *In the Matters of Phillips Petroleum Company*, docket Nos. G-1148, G-3175, G-5333, G-6621, G-7773, G-8623, G-8695, G-8883, G-10,359, G-10,793, G-10,883, G-11,125, and G-11217 order issued December 14, 1956.

spiral escalation provisions of Phillips' said rate schedule, be accorded consideration by the Commission as an increased rate filing with an effective date prior to September 15, 1957, the date upon which Michigan-Wisconsin's related increased rate filing in docket No. G-12,292 may be made effective subject to refund of any excess charges thereafter found unjustified. Since Phillips' said increased rate filing of March 15, 1957, is based upon the same spiral escalation provisions in Phillips' FPC Gas Rate Schedule No. 4 that underlie Phillips' increased rate filing in the proceeding in docket No. G-10,793, for sales of natural gas to Michigan-Wisconsin, the question as to whether such recurring rate increase filings under the same escalation provisions in a rate schedule are contrary to the public interest is also presented for consideration and determination.

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The Commission finds:

(1) It is appropriate and in the public interest that the hearing being held in the consolidated docket Nos. G-1148, *et al.*, include among other things, the issues involved in docket Nos. G-10,793, G-10,883, and G-11,217 whether (a) Phillips' increased rate filings in the proceedings in docket No. G-11,217 for sales of natural gas to El Paso constitute unilateral filings within the meaning of the *Mobile* case (*United Gas Pipe Line Company* v. *Mobile Gas Service Corporation*, 350 U.S. 432); and (b) the spiral escalation provisions contained in Phillips' FPC Gas Rate Schedules Nos. 7, 8, 32, 33, 64, and 243 applicable to sales of natural gas to El Paso and the similar escalation provisions in Phillips' FPC Gas Rate Schedules Nos. 4 and 5 applicable to sales of natural gas to Michigan-Wisconsin and to Panhandle, respectively, are so ambiguous in language and so inflationary in effect as to contravane the public interest and conflict with the regulatory powers of the Commission, or are otherwise unlawful.

(2) El Paso's request for a limited hearing upon the specific issues enumerated in paragraph (1), above, should be denied.

(3) It is appropriate in carrying out the provisions of the Natural Gas Act to prescribe terms and conditions with respect to refunds by Phillips as hereafter provided.

The Commission orders:

(A) El Paso's request for a hearing limited solely to the issues presented in docket No. G-11,217, as set forth in paragraph (1) herein, is hereby denied.

(B) Upon execution by Phillips of the agreement and undertaking described in paragraph (D) below and acceptance thereof, evidence by letter addressed to Phillips by the Secretary of the Commission, the rates, charges, and classifications set forth in the supplements to its rate schedules as enumerated above, shall be effective as of March 11, 1957, subject to further orders of the Commission in this proceeding.

(C) Phillips shall refund at such times and in such amounts to the persons entitled thereto, and in such manner as may be required by final order of the Commission, the portion of the increased rates found by the Commission in this proceeding not justified, together with interest thereon at the rate of 6 percent (per) annum from the date of payment to Phillips until refunded; shall bear all costs of any such refunding; shall keep accurate accounts in detail of all amounts received by reason

of the increased rates or charges effective as of March 11, 1957, for each billing period, specifying by whom and in whose behalf such amounts were paid; and shall report (original and four copies) in writing and under oath, to the Commission monthly, or quarterly if Phillips so elects

and so notifies the Commission within 30 days, for each billing period, and for each purchaser the billing determinants of natural gas sales to such purchasers and the revenues resulting therefrom, as computed under the rates in effect immediately prior to March 11, 1957, and under the rates allowed by this order to become effective, together with the differences in the revenues so computed.

(D) As a condition of this order, within 15 days from the date of issuance hereof, Phillips shall execute and file with the Secretary of this Commission its written agreement and undertaking to comply with the terms of paragraphs (C) and (D) hereof, signed by a responsible officer of the corporation evidence by proper authority from the Board of Directors, and accompanied by a certificate showing service of copies thereof upon all purchasers under the rate schedule involved, as follows:

Agreement and Undertaking of Phillips Petroleum Company to Comply with the Terms and Conditions of Paragraphs (C) and (D) of Federal Power Commission's Order Making Effective Proposed Rate Change

In conformity with the requirements of the order issued 1957, in dockets Nos. G-11,217, et al., Phillips Petroleum Company hereby agrees and undertakes to comply with the terms and conditions of paragraph (C) of said order and has caused this agreement and undertaking to be executed and sealed in its name by its officers, thereupon duly authorized in accordance with the terms of the resolution of its Board of Directors, a certified copy of which is appended hereto, this day of 1957.

PHILLIPS PETROLEUM COMPANY

By:

President

Attest:

Secretary

(E) If Phillips shall, in conformity with the terms and conditions of paragraph (C) of this order, make the refunds as may be required by order of the Commission, the undertaking shall be discharged, otherwise it shall remain in full force and effect.

By the Commission.

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Decision

In the Matters of

Docket No. G-1148

Docket Nos. G-3175, G-4333, G-6621, G-7773, G-8623, G-8695, G-8883, G-10359, G-10793, G-10883, G-11125, and G-11217

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[* The Examiner's Decision, which has not been printed herein in its entirety, appears in full at 24 FPC 590-818]

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Zwerdling, Presiding Examiner: This case is an outgrowth of the historic June 7, 1954 decision of the United States Supreme Court in *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672, which held that the Federal Power Commission has jurisdiction "over the rates of all wholesales of natural gas in interstate commerce, whether by a pipeline company or not and whether occurring before, during, or after transmission by an interstate pipeline company."[1]

The Commission on October 28, 1948 had instituted *In the Matter of Phillips Petroleum Co.*, Docket No. G-1148, an investigation under Sec. 5(a) of the Natural Gas Act to determine whether Phillips was a natural-gas company within the jurisdiction of the Commission, and, if so, whether its natural-gas rates were unjust or unreasonable. The hearing, held in 1951, was directed solely to the jurisdictional question, and culminated in a Commission decision issued August 16, 1951, holding that Phillips was not a "natural-gas company" within the meaning of the Natural Gas Act. Accordingly, by an order accompanying that opinion the Commission terminated the investigation proceeding. On appeal, the decision of the Commission was reversed by the Court of Appeals for the District of Columbia[2], and on June 7, 1954 the United States Supreme Court affirmed the opinion of the Court of Appeals.

In compliance with the mandate of the Court of Appeals, the Commission on November 22, 1954 issued an order in Docket No. G-1148, vacating its previous termination of the G-1148 proceedings, and reinstituting the Sec. 5(a) investigation of Phillips' jurisdictional rates and charges under that docket. By Order issued May 28, 1956, the Commission consolidated the reinstated proceedings in

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[1] 347 U.S. at 682.

[2] *State of Wisconsin* v. *Federal Power Commission*, 205 F. 2d 706 (C.A.D.C., 1953).

Docket No. G-1148 for hearing with certain Sec. 4(e) rate increase proceedings filed by Phillips in Docket Nos. G-3175, G-4333, G-6621, G-7773, G-8623, G-8695, G-8883 and G-10359, and directed that hearing in such consolidated proceeding should commence June 26, 1956. After the hearing commenced, and during the pendency thereof, the Commission issued additional orders on July 25, 1956, October 24, 1956 and December 14, 1956, adding subsequent Sec. 4(e) rate increase filings by Phillips in Docket Nos. G-10793, G-10883, G-11125, and G-11217 to the instant consolidated proceeding. The increased rates proposed by Phillips in such Sec. 4(e) rate filings have since become effective at various dates subject to undertaking to assure refunds of any excess charges, and Phillips is currently collecting such increased rates and charges under such undertakings.

The hearing in the instant consolidated proceeding commenced on June 26, 1956 and was closed on December 18, 1957. It totaled 82 hearing days, and the hearing record comprises 10,620 pages of transcript and 235 exhibits.[3]

The parties include Phillips, the Staff of the Commission, and some thirty-one interveners.

Four major, full-scale cost-of-service studies were presented—by Phillips, the Staff, the Eastern Seaboard In-

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[3] Because the Commission order of November 22, 1954, *supra*, treated the instant proceeding as a reopening and continuance of the original 1951 Phillips hearing in Docket No. G-1148, the pagination of the transcript and the numbering of the exhibits in the instant hearing were treated in the same way. Accordingly, the record of the instant hearing commences with Volume 42, page 6223, and the first exhibit is Exhibit No. 197. As a matter of fact, since the original 1951 Phillips hearing was devoted solely to the jurisdictional question, and since that question has been finally disposed of by the Supreme Court's *Phillips* decision of June 7, 1954, the record made in the original 1951 hearing is not of interest in connection with this decision.

terveners (Eastern)[4], and the State of Wisconsin and Public Service Commission of Wisconsin (Wisconsin). In addition, evidence on various selected aspects of the cost of service and other problems was presented by certain other interveners—i.e., Southern California Gas Company and Southern Counties Gas Company of California (Southern); Pacific Gas and Electric Company (Pacific); Consolidated Edison Company of New York, Inc. (Consolidated Edison); El Paso Natural Gas Company (El Paso); and Minneapolis Gas Company.

It is relevant to note here a motion made by Wisconsin during the latter stages of the hearing, which was rejected by the Examiner, followed by a Commission order affirming the Examiner's ruling on December 17, 1957. During the direct testimony of the Wisconsin cost-of-service witness, Van Scoyoc, at the October 15, 1957 session, he indicated at various points that the record, in his opinion, was deficient in that certain types of data which he characterized only in general terms was not included. At the conclusion of Van Scoyoc's

direct testimony, Wisconsin's counsel orally moved the Examiner to make an order or otherwise direct that the Staff make the necessary studies and present on the record voluminous additional data of the type required to fill such alleged gaps. At the time when this request was made by Wisconsin, the Phillips and Staff cases in this proceeding had already long since been presented on both direct and cross-examination, and the request followed the long recess which had been granted for the period from June 13 to October 7, 1957, to provide the interveners with an op-

[4] Four Eastern Seaboard distribution company interveners, Long Island Lighting Company, Philadelphia Electric Company, Public Service Electric and Gas Company, and The United Gas Improvement Company, cooperated in making a joint presentation throughout this proceeding.

portunity to prepare their own cases for presentation at the October session. It also appeared that during the lengthy cross-examination of the Phillips' witnesses prior to such recess, counsel for the various interveners and the Staff from time to time had submitted various requests to Phillips for additional data of all types, which they contended was essential for the preparation of their cases. In order to handle this problem on an orderly basis, the interveners finally presented Phillips with a coordinated written list incorporating all of such additional data requests, and prior to the October 1957 session such data had in fact been made available by Phillips (101:13,407). In spite of these facts, no request for any such additional data as that outlined by Van Scoyoc had been made by Wisconsin in any form until the oral motion was made at the close of Van Scoyoc's direct testimony on October 15, 1957.

Under these circumstances, the Examiner denied the Wisconsin motion. On November 4, 1957, Wisconsin filed with the Commission a document entitled "Motion of State of Wisconsin and Public Service Commission of Wisconsin for Order Directing Staff to Supply Additional Evidence for Record." In this written motion, which the Commission treated as an appeal from the Examiner's ruling, Wisconsin requested that the Commission Staff undertake a study to obtain and incorporate in the record evidence with respect to the following matters:

(1) basic data necessary for the determination of just and reasonable rates for appropriate areas;

(2) comprehensive data with respect to gas purchased by Phillips;

(3) comprehensive data with respect to royalty transactions and lease buying and selling transactions;

(4) additional data with respect to cycling operations;

(5) additional data with respect to the methods and procedures utilized by Phillips in allocating income taxes to departments;

(6) additional data with respect to gas balance;

(7) additional data with respect to gasoline plants; and

(8) additional data with respect to Phillips' adjustments to the test year for "known" changes.

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By order issued on December 17, 1957, the Commission found that:

> " . . . Movants' request at this stage of the proceedings for the acquisition and inclusion of the substantial amount and variety of additional evidence is neither timely nor warranted."

Accordingly, the Wisconsin appeal from the Examiner's ruling was denied.

On December 2, 1957, two weeks before the lengthy hearing closed, Staff counsel orally moved the Examiner to grant a recess of six months in order to permit the Staff to make a further investigation of Phillips' books and records, for the purpose of adding to the record at a later session comprehensive data with respect to the costs of Phillips' joint product wells, broken down on an area basis, and the necessary allocation of such joint product costs on an area basis. The Staff contended that in the event the Commission should ultimately conclude that Phillips' rates should be fixed on an area basis, rather than a system-wide basis, it would be important for the record to contain such data. Actually, in its initial presentation of its case-in-chief in the summer of 1956 the Staff had presented a cost of service broken down into certain selected areas, using

actual cost figures for the dry gas produced by Phillips in such areas. However, because the Staff in the course of this presentation adopted the technique of simply imputing or assigning to gas produced from the joint product wells the same unit costs which had been derived for the dry gas production on an area basis[5], the Staff did not present actual cost figures on an area basis for the gas produced from the joint product wells. The purpose of the Staff motion of December 2, 1957 for the six months delay was to obtain and present on the record the required evidence to fill this gap.

As already noted, this Staff motion was made for the first time in the closing days of the already lengthy hearing, at a time when the record had already been completed with respect to: (a) the Staff case on direct and cross-examination; (b) the Phillips case on direct and cross-examination; (c) the presentations by various groups of interveners, on direct and cross-examination. The only unfinished business remaining open at that time was the presentation of a brief rebuttal case by Phillips. The Examiner denied the Staff motion on the ground that: (a) there was no justification for the delay in making such a motion until the closing weeks of the hearing, since the problems raised in the Staff motion had been apparent and obvious throughout the preceding eighteen months of hearing; (b) even if the Staff request had been granted

and the additional evidence sought thereby had been added to the record in the form of additional Staff exhibits, prepared upon the basis of the principles and positions adopted by the Staff in its cost-of-service study in this proceeding, such an expanded record would still not neces-

[5] This technique, as adopted by the Staff, will be described in detail at a later point in this decision.

sarily include all of the data required for area rate fixing, in the event the Commission should ultimately fail to adopt all of the Staff cost-of-service positions or techniques; (c) if the Staff motion had been granted, procedural due process would have required that both Phillips and the various intervener groups be subsequently provided with an opportunity to submit further substantial evidence of their own, directed to such a new Staff presentation, thus indefinitely delaying the closing of the record in this important proceeding; (d) respect for the administrative process required that the hearing be concluded and that the point of decision be reached without such interminable delay.

By order issued December 17, 1957 the Commission affirmed the Examiner's ruling.

The hearing was concluded on December 18, 1957. Thereafter comprehensive and extremely helpful briefs were filed with the Examiner by Phillips, the Staff, Eastern, Wisconsin, Southern, Pacific, Consolidated Edison, El Paso, Michigan Wisconsin Pipe Line Company (Michigan Wisconsin), Northern Natural Gas Company and Permian Basin Pipeline Company, Panhandle Eastern Pipe Line Company (Panhandle), Minneapolis Gas Company, Brooklyn Union Gas Company, Texas Gas Transmission Corporation, and the County of Wayne, Michigan. The last reply briefs were filed as of May 5, 1958, and the case is now ready for decision.

As a result of the excellent and helpful presentations made by the various parties in this case, the instant record includes a comprehensive presentation with respect to all of the major, key problems, including four different complete cost-of-service studies, and including the presentation and testing by cross-examination and rebuttal of the major alternative allocation methods which have thus far been proposed in independent producer rate cases currently

pending before this Commission. It is further concluded that, in spite of the allegations made in the Wisconsin and Staff motions referred to above, the record made in the instant proceeding does provide an adequate and sufficient basis for a reasonable resolution of all the issues presented in this case.

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I. The Landmark Court and Commission Decisions in the Field of Producer Regulation, by Which this Case is Governed

In proceeding to our discussion of the important producer problems involved here, it will be helpful to restate and to bear in mind certain basic and controlling statements made by the Supreme Court in its historic *Phillips* decision, *supra*. The Court there referred to its earlier decision in *Interstate Natural Gas Company* v. *Federal Power Commission*, 331 U.S. 682, involving a company which produced or purchased natural gas, which it in turn sold and delivered to three interstate pipeline companies. The Court then quoted with approval the following language from its earlier *Interstate* decision:

> "'We have held that these sales are in interstate commerce. It cannot be doubted that their regulation is predominantly a matter of national, as contrasted to local concern. All the gas sold in these transactions is destined for consumption in States other than Louisiana. Unreasonable charges exacted at this stage of the interstate movement become perpetuated in large part in fixed items of costs which must be covered by rates charged subsequent purchasers of the gas, including the ultimate consumer. It was to avoid such situations that the Natural Gas Act was passed.' Id., at 692-693" (347 U.S. at 680).

At the conclusion of its decision in the *Phillips* case the Supreme Court stated:

> "Regulation of the sales in interstate commerce for resale made by a so-called independent natural-gas producer is not essentially different from regulation of such sales when made by an affiliate of an interstate pipeline company. In both cases, the rates charged may have a direct and substantial effect on the price paid by the ultimate consumers. Protection of consumers against exploitation at the hands of natural-gas companies was the primary aim of the Natural Gas Act. *Federal Power Commission* v. *Hope Natural Gas Co., supra*, at 610. Attempts to weaken this protection by amendatory legislation exempting independent natural-gas producers from federal regulation have repeatedly failed, and we refuse to achieve the same result by a strained interpretation of the existing statutory language."

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Since the Supreme Court's historic holding in the *Phillips* decision, *supra*, that the Commission has jurisdiction over independent producer natural gas sales in interstate commerce, there have been two major Court of Appeals decisions dealing with the broad problem as to how "just and reasonable" rates should be determined for such producer sales under the Natural Gas Act.

The basic, controlling decision in this area was handed down on December 15, 1955 by the Court of Appeals for the District of Columbia Circuit in the *City of Detroit* case, *City of Detroit* v. *Federal Power Commission*, 230 F. 2d, 810, *certiorari* denied, 352 U. S. 829. As will be noted below, the Commission since that time has regarded the *City of Detroit* decision as controlling in independent producer rate cases. Under the circumstances, it will be

helpful at this point to summarize the holding of the *City of Detroit* case at some length. That case was a proceeding to determine "just and reasonable" rates for the jurisdictional sale of natural gas by Panhandle Eastern Pipe Line Company, and the issue before the Court was whether the Commission had erred in fixing "just and reasonable" rates for Panhandle's own produced gas on the basis of "field price" or "commodity value." The Court held that the Commission had erred, and in the course of its decision setting aside the order of the Commission the Court laid down the following basic principles:

(1)

"... the primary aim of the Act in the words of the Supreme Court is 'to protect consumers against exploitation at the hands of natural gas companies'. *Federal Power Commission* v. *Hope Natural Gas Company*, 320 U. S. at 610. See also, Id. at 612; *Phillips Petroleum Company* v. *Wisconsin* 347 U. S. 672, 685." (230 F. 2d at 815).

The Court further stated that in considering whether investor and consumer interests were properly balanced,

"... we must keep in mind the basic purpose of the statute to protect consumers from excessive ..tes, though at the same time the statute affords the support of public authority to the regulated utility." (230 F. 2d at 816).

(2) The Court noted that:

"In *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U. S. 591, the Supreme Court approved use of the 'prudent investment' rate-base method for establishing rates to be charged by natural gas

companies. Since then, until the instant case, the Commission has consistently employed this rate-base method, under which rates are considered 'just and reasonable' if they will return to the company a certain percentage of profit on its rate base. The rate base is a figure representing the money prudently invested in the properties and equipment utilized in the company's transmission and production business. The percentage of profit prescribed by the Commission depends upon a variety of factors, such as the risks of the business, the necessity for attracting capital, and the desirability of lower cost of gas to the public. In order to return a profit on the rate base the rates are set high enough to recover all costs of service, including taxes, depreciation, depletion, and all operating expenses chargeable to production and transmission." (230 F. 2d at 813).

(3) Although holding that the use of field price was not necessarily prohibited,[6] the Court noted:

"The fair field price . . . is not an item of cost. Its inclusion as an amount to be recouped from consumers as though it were a cost incurred by Panhandle must find some other justification within the periphery of the 'just and reasonable' standards. It is not an ingredient of any of the usual needs of a regulated utility, that is, to obtain revenues for operating expenses, for preservation of its financial integrity, for capital costs, for servicing of debt and payment of dividends, or for delayed rentals or costs of exploration and development. See *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U. S. at 605, 615. The Commission, how-

[6] 230 F. 2d at 814, 815.

ever, advances other factors of an economic character as justification. We may not deny these a place in the total structure underlying rates if, in a balancing of investor and consumer interests, they are brought by evidence and findings into rational relationship to what is 'just and reasonable'." (230 F. 2d at 816).

(4) The Court then held that use of the field price method can be justified "only in terms of a demonstrated public interest"; that when so used

". . . the evidence and findings must show that the increase in rates thus caused is no more than is reasonably necessary for the purposes advanced for any increase." (230 F. 2d 818).

(5) The Court finally held:

"While as we have indicated the Commission may be empowered to consider some of these factors it must also, and always, relate its action to the primary aim of the Act to guard the consumer against excessive rates. If the Commission contemplates increasing rates for the purpose of encouraging exploration and development, or the ownership by pipeline companies of their own producing facilities, it must see to it that the increase is in fact needed, and is no more than is needed, for the purpose. Further than this we think the Commission cannot go without additional authority from Congress." (230 F. 2d 817).

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"Furthermore, it is seen that when we refer to an 'increase' we mean an increase in the rates above those which would result from use of the conventional rate-base method. For, though we hold that method not to

be the only one available under the statute, it is essential in such a case as this that it be used as a basis of comparison. It has been repeatedly used by the Commission, and repeatedly approved by the courts, as a means of arriving at lawful—'just and reasonable'—rates under the Act. Unless it is continued to be used at least as a point of departure, the whole experience under the Act is discarded and no anchor, as it were, is available by which to hold the terms 'just and reasonable' to some recognizable meaning." (230 F. 2d 818-19).

Subsequently in Opinion No. 300, *In the Matters of Union Oil Company of California, et al.*, Docket Nos. G-4331, *et al.* (December 6, 1956), the Commission held that the *City of Detroit* decision was

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controlling in independent producer rate cases. Later, in its "Order Denying Petitions for Rehearing and Amending Order Accompanying Opinion No. 300" (issued January 31, 1957), the Commission held that the *City of Detroit* decision required:

". . . the presentation of rate base and cost evidence as a point of departure plus a showing that any additional allowance is no more than is reasonably necessary for the purposes advanced for any increase. . . .
"Significantly, in the *City of Detroit* case, the court was interpreting the substantive statutory and constitutional standards which we must follow. These are applicable to the rates of all natural-gas companies whether they be interstate transmission companies or independent producers. We carefully considered the applicants' contentions with respect to the *City of Detroit* case before we issued our Opinion No. 300 and could find no legal basis for excluding independent

producers from the application of the law of that case. Further, this conclusion is consistent with the effect of the decision in *Phillips Petroleum Company* v. *Wisconsin*, 347 U. S. 672 (1954)." (p. 4 of Mimeo. Order)

On review of Opinion No. 300, this holding was affirmed by the Court of Appeals of the Fifth Circuit in *Bel Oil Corporation* v. *Federal Power Commission*, 255 F. 2d 548 (April 23, 1958).[7] In the course of its decision upholding the Commission in that case, the Court quoted at length, as being germane to the Commission decision it was there affirming, the following language from the *City of Detroit* decision:

"For, though we hold that method [the rate base or cost of service method] not to be the only one available under the statute, it is essential in such a case as this, that it be used as a basis of comparison. It has been repeatedly used by the Commission, and repeatedly approved by the courts, as a

means of arriving at lawful—'just and reasonable' rates under the Act. Unless it is continued to be used at least as a point of departure, the whole experience under the Act is discarded and no anchor, as it were, is available by which to hold the terms 'just and reasonable' to some recognizable meaning." (255 F. 2d at 551-552)

The Court further held, in the *Bel Oil decision*:

"We do not hold that evidence of field price is irrelevant. We do hold that evidence of unregulated prices in the field is not sufficient to warrant a finding by the

[7] Certiorari denied October 13, 1958.

> Commission that a price comparable to them is just and reasonable within the intendment of the Natural Gas Act. Neither is evidence of the field price when coupled with the opinion of experts that the price must be high enough to provide an incentive for exploration and development of new sources of supply." (255 F. 2d at 553)

Since the *City of Detroit* decision, *supra*, the Commission has consistently held in numerous independent producer rate cases that the conventional rate base method of rate-making must be used as a basis of comparison or point of departure.[8] The Commission has most recently reaffirmed that position in strong language in its Order Denying Applications for Rehearing and Motions for Stay, *In the Matters of Pan American Petroleum Corporation, et al.*, Docket Nos. G-8697, *et al.*, (issued June 6, 1958), where it stated:

> ". . . the companies cannot show their proposed increased rates are just and reasonable, absent evidence of cost-of-service or revenues requirements . . .[9]

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The Court of Appeals for the Fifth Circuit has recently had occasion to comment upon this situation again in a decision issued on February 20, 1959, in *Forest Oil Corporation, et al.*, v. *Federal Power Commission* (CCA 5, No. 16844). The *Forest Oil* case was identical in character with the *Bel Oil* case, *supra*, and presented the same questions

[8] *Sun Oil Co., et al.*, Docket Nos. G-8288, *et al.*, Feb. 6, 1957; *Orange Grove Oil and Gas Corporation, et al.*, Docket Nos. G-8518, *et al.*, Feb. 6, 1957; *Crow Drilling Company, Inc., et al.*, Docket Nos. G-6622, *et al.*, Feb. 6, 1957; *H. F. Sears, et al.*, Docket Nos. G-6502, *et al.*, Sept. 3, 1957; *Delhi-Taylor Oil Corp., et al.*, Docket No. G-6504, Sept. 30, 1957.

[9] Page 4, Mimeo. Order.

for review—i.e., (1) whether field price evidence alone was sufficient to make a *prima facie* case that the producer's proposed rates were just and reasonable, and (2) whether, in the event such evidence was not regarded as sufficient, the record should be reopened to give the petitioners one more opportunity to present satisfactory evidence in support of their rate proposals. The Court adopted the same position which it had taken in the *Bel Oil* case, *supra*, affirming the Commission's finding that field price evidence alone was not sufficient, but directing that the proceedings be reopened to afford petitioner

> "reasonable opportunity to adduce such evidence as it may be advised is relevant to the inquiry whether the proposed rate is just and reasonable".

Although there was nothing further before the Court for disposition, it noted the persistent and strong pleas which had been made by petitioner's counsel in the course of oral argument for some further guidance as to the types of evidence which might be deemed relevant on the issue of just and reasonable rates. Because of these pleas, the Court in the *Forest Oil* decision proceeded to set forth several pages of general observations, by way of *dictum*.

That Court without a doubt has been amply supplied, both in the *Bel Oil* series of cases and in the *Forest Oil* case, with all of the general arguments which all segments of the natural gas industry, the Staff of the Federal Power Commission, and State regulatory commissions have now been making since June 7, 1954 on the general theoretical question whether producer rates can or should be fixed under the rate base or cost of service method, whether that method is administratively feasible or impossible of administration, whether it produces sensible or ludicrous results, *etc.* It is of utmost importance, however, to note that all of the arguments made on these subjects up to this

time have been made *in a vacuum*. The fact of the matter is that up to this date neither the Federal Power Commission itself, nor the Court of Appeals for the Fifth Circuit, nor any other Court, has yet had the opportunity to examine a record made in a major, representative producer rate case, in which the rate base or cost of service method has actually been applied to the books and records of a specific producer, and in which an actual attempt was made to develop "just and reasonable" rates for the producer by that approach.

That very opportunity, however, is now provided, for the first time, in the instant *Phillips* proceeding. In view of the circumstances outlined above, it is here concluded that the general observations set forth by the

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Court in the *Forest Oil* decision by way of *dictum* were intended by the Court to be treated only as preliminary and advisory in character, and not as a firm and binding precedent which would be dispositive of any of the issues involved in the instant *Phillips* proceeding.

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II. General Attacks on the Cost-of-Service Method

However, in spite of the fact that the Courts and the Commission have thus consistently held that in determining "just and reasonable" rates for jurisdictional natural gas sales by independent producers the conventional rate-base, or cost-of-service method must be used at least as a point of departure, arguments continue to be made in producer rate cases before this Commission that producer rates should not be fixed under the cost-of-service or rate-base method. In the instant proceeding thirteen pages of the El Paso brief are devoted to arguing that "independent producer rates cannot be determined by the traditional rate base cost of service method applicable to transportation

utilities" (El Paso brief, pages 20-33). Contentions are made that the cost-of-service method, as applied to producer rate cases, is unworkable, that it presents monstrous problems which are impossible of solution, that it is administratively unfeasible, and that it produces incongruous results.

Since this is the first major, comprehensive cost-of-service producer rate case to reach the point of decision before this Commission, it is anticipated that it will provide a vehicle for resolving many of the major problems connected with producer rate regulation which have remained unsolved up to this time. Furthermore, in view of the comprehensive and helpful cost-of-service presentations made in this proceeding by Phillips, a number of representative groups of interveners, and the Staff, an opportunity has been provided to observe concretely, on the basis of fact, rather than on the basis of academic, general speculation, the problems encountered in attempting to fix producer rates on a cost-of-service basis, the methods which are available to resolve those problems, and the nature and reasonableness of the results obtained. Accordingly, it would seem useful to set forth here certain relevant over-all conclusions, based upon what was developed in this proceeding.

It may be noted at the outset that Phillips itself has taken the position throughout this proceeding that its "just and reasonable" rates should be determined under the cost-of-service method, rather than under a field price method. (92: 12,481, lines 10-15)[10]

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The Phillips position was clearly stated by its policy

[10] Based on its claimed cost-of-service as proposed by Phillips in this proceeding, it has developed proposed rates ranging from a high of 22.75¢ per Mcf to a low of 16.5¢ per Mcf, depending on delivery conditions. (Phillips initial brief, page 169) Such maximum proposed rate of 22.75¢ is higher than any of the claimed "commodity value" or "field price" levels presented in this proceeding.

witness, Stanley Learned, Chairman of the Executive Committee and Assistant to the President of Phillips, during cross-examination by El Paso counsel. In the course of this interrogation El Paso counsel referred to the question as to how the concept of commodity value (or field price) could be employed in regulation. The following colloquy then occurred:

"Q. And do I understand that you think that that should be the method by which the prices of independent producers should be regulated, rather than by the cost of service method?

A. No, I do not think so.

Q. Did you formerly espouse that method for regulation?

A. The value method?

Q. Yes.

A. No, sir.

Q. *Now, is it your position, sir, that when these parties at arms-length deal and effect a price which represents the value, as you have defined it, that that is the fair and equitable price?*

A. Under regulation?

Q. Either way, sir.

A. *It is not necessarily fair and equitable under regulation.*

Q. You think then, that despite the fact that the parties agree at arms-length with these elements that you have in mind, that nevertheless that should be abandoned and a cost of service method rather instituted to determine the price?

A. *Well, under regulation I think that the interests of the consumer and the interests of the public have to be given consideration, and they may not have been given consideration at the time that the contract was*

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entered into." (93: 12,494, line 23—12,495, line 22; emphasis supplied.)

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It is also relevant to note that, on the basis of its own *actual* experience in presenting its instant case on a cost-of-service basis, Phillips has not at any time taken the position that the cost-of-service method, as applied to producer rate cases, is unworkable, or that it presents unduly complex problems. On the contrary, the Phillips initial brief summarizes the situation as follows:

"Important differences exist among the parties in the various methods of allocating costs. Before discussing differences, however, it is important to note the similarities. The differences in basic approach are not as great as they might appear. While there was disagreement among the parties with respect to specific matters, there was complete unanimity with respect to many of the fundamental principles which serve as the starting point for any method of cost allocation." (page 83)

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"In addition to these points of agreement on basic principles, it becomes clear upon analysis that many of the apparent differences are merely differences in the application of the same method, rather than differences in choice of methods. The result is that, while the various cost studies by no means represent complete harmony, there is surprising unity of thought to a novel problem which is by its nature complex and filled with potential points of controversy." (page 85)

We now turn to some of the major contentions made by those who oppose the use of the cost-of-service method for the regulation of producer rates:

(1) It is pointed out that over four years have now elapsed since the Supreme Court's historic *Phillips* de-

cision and that no final solutions have yet been arrived at for the major problems involved in applying a cost-of-service method to the determination of "just and reasonable" producer rates—and this fact is advanced as evidence that the complexity of the problems is such as to render the cost-of-service method unworkable in this field. However, a somewhat different impression will be obtained if the history of the past four years is briefly examined. The fact of the matter is that the first two years subsequent to the Supreme Court's *Phillips* decision on June 7, 1954, constituted a phase during which the producers abstained from presenting any evidence with regard to cost-of-service or revenue requirements. During this period the evidence presented by producers in producer rate hearings before the Commission consisted only of such matters as field price evidence, together with testimony and exhibits designed to persuade the Commission that the public interest would be better served if producer prices were left to be fixed by the law of supply and demand rather than by regulation. This phase culminated in the Commission decision issued December 6, 1956, in the

Union Oil case (Op. No. 300, *supra*), subsequently affirmed by the U. S. Court of Appeals for the 5th Circuit on April 28, 1958,[11]—in which it was held that evidence of field prices and evidence of arm's-length bargaining alone were not sufficient to sustain the burden of proof as to "just and reasonable" rates, imposed upon the producers under Sec. 4(e) of the Natural Gas Act. Thereafter the second phase commenced in June 1956 with the instant *Phillips* proceeding in which, as noted above, a comprehensive cost-of-service presentation has been made by Phillips and the other parties. In addition, a number of other major pro-

[11] *Bel Oil Corporation* v. *Federal Power Commission*, 255 F. 2d 548.

ducer rate cases have been in hearing before this Commission, in which comprehensive cost-of-service studies have been presented. It would seem reasonable to expect that this second phase, which commenced only two years ago, will produce the experience and the understanding required to develop reasonable, fair and workable solutions for the major problems.

(2) Those who oppose the use of the cost-of-service method also stress the size of the record and the length of the hearing in the instant *Phillips* proceeding as evidence of the allegedly impossible complexity of the task. However, it is important to note in this connection that the instant proceeding represents the first major producer rate case before this Commission to reach the point of decision; that the Commission at this point is still at the threshold of the problem of producer rate regulation, and that no firm positions have yet been reached by the Commission on any of the major issues involved in this area. Under these circumstances, it was inevitable that a very substantial portion of the record made in this proceeding should necessarily fall into the following major categories:

(a) The presentation by Phillips, numerous intervener groups and the Staff of a large number of different, alternative proposals for the handling of various allocation problems, and for the solution of other issues such as the type of rate of return to be developed for producers, the treatment of "phantom" taxes, etc. Each one of these numerous alternative proposals was, of course, followed by detailed cross-examination and rebuttal.

(b) The presentation by Phillips of voluminous general, industry-wide data and material, designed to indicate certain allegedly basic characteristics and trends operating with respect to the natural gas

production industry—i.e., the national gas supply picture, increasing market requirements, and increasing cost trends. This type of evidence was designed to suggest that where various alternative methods are available, a method liberal to the producer should be adopted.

It is important to bear in mind, however, that the length and complexity of the instant *Phillips* proceeding cannot fairly be regarded as representative of the situation which will be commonly encountered in future producer rate proceedings, once the Commission has firmly established the applicable standards and methods to be used in determining producer rates. From that point on, the two categories of evidence outlined above, which consumed so much time in the instant *Phillips* proceeding, will no longer be required.

(3) A further argument is made with respect to the claimed difficulty of obtaining from the producer's records the type of data required to develop a true cost of service and to make the necessary allocations. It is contended that in many cases such data is not available in the required form because producers normally do not keep their books in this manner; that it accordingly imposes a serious burden upon the producers to develop such data from the information on their books. It is interesting to note, however, that before the record was closed in the instant proceeding all reasonable requests made to Phillips by the interveners and Staff for additional data had been met. No contention can seriously be made here that the instant record does not contain all the data with respect to Phillips' operations which is reasonably required for the resolution of the major problems in this case.

It is also relevant to note that difficulties similar to those referred to above were ultimately solved in the early years of this Commission's regulation of pipeline rates by the adoption of such techniques as a Uniform System of Accounts, under which pipeline companies subject to Commission regulation were required to set up and maintain their records in such a way that the required data would at all times be readily available. There is no reason to doubt that the Commission will be able to work out similarly effective techniques for solving such problems in connection with the exercise of its jurisdiction over independent producers.

(4) One of the major arguments made against the use of the cost-of-service method for regulation of producer rates is directed to the complexity of the allocation problems arising in connection with joint product wells. As in the case of most producers, Phillips produces gas not only from dry gas wells, but also from joint product wells. The latter category includes casinghead gas wells, producing both oil and casinghead gas, and gas condensate wells which produce condensate gas and condensate liquids.[12] Since the pro-

duction costs of such joint product wells are joint costs, it becomes necessary to allocate such joint costs as between oil and gas. In addition, joint exploration costs must be allocated as between the two products. A major portion of the record in this proceeding was directed to the presentation of alternative methods for making such allocations. Opponents of the cost method argue that such allocations are tremendously complicated and difficult; that because there is in fact no such thing as a *separate* cost for the gas

[12] The gas produced from joint product wells is also referred to as "associated gas".

produced from a joint product well, the results arrived at by the use of any of such allocation methods do not represent the costs *actually* incurred with respect to the separate product, and, accordingly, the entire effort to determine which allocation method should be adopted is misdirected.

It can be agreed, at the outset, that there is in fact no such thing as a separate cost for the gas produced from a joint product well, and that allocations must, therefore, be made. However, this fact becomes less impressive when it is realized that pipeline rate proceedings, where the cost-of-service method has for years constituted the established and accepted approach, similarly involve complicated and difficult allocation problems. It will help to restore this situation to perspective if a brief reference is made here to some of the complex allocation problems commonly encountered in pipeline rate proceedings.

(a) One such pipeline allocation problem, which is present in practically all pipeline rate proceedings, is the determination as to what portion of system-wide costs should be classified as demand costs, and what portion as commodity costs. This allocation becomes necessary because pipelines perform both a capacity and a volumetric function, and therefore represent, in a sense, a joint facility.

The leading Commission decision on this particular problem was *In the Matter of Atlantic Seaboard Corporation, et al.*, 11 F.P.C. 43 (April 25, 1952). The language there used by the Commission on the subject of cost allocation can be read with interest and profit here:

> "In this, as in most of our natural gas rate proceedings, we are confronted with a cost allocation problem.
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> • • • • • • • • • •
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> "Because this question of proper allocation of costs is of such great importance in practically all rate proceedings before us—and usually, as here, is one of the most controversial of issues—we consider it appro-

priate to set out at some length our views as to proper methods of cost allocation so that all may be informed and guided in situations which may be substantially similar to the conditions here present.

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"The controversy generally engendered in rate proceedings as to the proper method for allocation of costs stems largely from the fact that the relative importance of the demand (capacity) and commodity (volume) functions cannot be measured with scientific accuracy. In the final analysis the allocations of cost to these respective functions are and must be largely dictated by informed judgment. Throughout our administration of the Natural Gas Act we have continually strived to develop—and improve—methods of allocation which would most properly apply to the natural-gas industry activities subject to our jurisdiction in the matter of rates. The methods used in the determination of early rate proceedings were modified somewhat in our latter decision in the Mississippi River Fuel Corp. case because additional experience under the methods first applied indicated the necessity for modification thereof. Further experience and knowledge gained since the time of our decision in the Mississippi River Fuel Corp. case—continuing study of this troublesome question—and the facts in evidence in this proceeding disclose the need for further departure from methods of allocation previously applied if results are to be obtained which are equitable to the various classes of customers and which attribute to each such class their proper share of the cost.

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"A natural-gas transmission facility performs both a capacity and a volumetric function. In this sense it is

a joint facility, which thus presents the problem, always difficult, of allocating joint costs. This problem is not unlike that which was presented to the Supreme Court in the Colorado Interstate case,[21] as to which it was stated: 'Allocation of costs is not a matter for the slide-rule. It involves judgment on a myriad of facts. It has no claim to an exact science. Hamilton, Cost as a Standard for Price, 4 Law & Contemporary Problems 321.' "

"[21] *Colorado Interstate Gas Co.* v. *Federal Power Commission*, 324 U. S. 581, 589." (11 F.P.C. pp. 52-54)

Although the pipeline cost allocation problem above described was thus recognized as an extremely difficult one, commonly involving one of the most controversial of issues, inherently incapable of being resolved with scientific accuracy, and therefore calling for the application of "informed judgment," it was not there contended and it has, in fact, never been contended that the presence of such complex allocation problems in pipeline rate proceedings requires or warrants the abandonment of the cost-of-service method in such cases.

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(b) Another complex allocation problem arises in pipeline rate proceedings where rates for a given pipeline system are fixed on a zone basis, rather than on a system-wide basis. In such cases it becomes necessary to determine what portion of the pipeline company's total system-wide costs should fairly be borne by each of the different zones, and this requires the application of complicated allocation methods. An illustrative case of this nature was Op. No. 281 (May 20, 1955), *In the Matter of Northern Natural Gas Co.*, Docket No. G-2217. The Commission there noted that

the allocation problem before it was not susceptible to solution with scientific accuracy. It stated:

> "In theory, the ideal, non-discriminatory, and non-preferential rate structure would be one designed to assess each point of sale and delivery with the total of the various cost components incurred in the rendering of service to each point. *But any attempt to arrive at such perfection would be . . . delusory.*[16]

[16] *Colorado Interstate Gas Company* v. *Federal Power Commission, et al.*, 324 U. S. 581, 589; Hamilton, Cost as a Standard of Price, *supra;* Op. No. 225, *In the Matter of Atlantic Seaboard Corporation, et al.*, pp. 17-19 (mimeo ed.)" (Op. No. 281, pages 21-22; emphasis supplied)

Nevertheless, in spite of the great complexity of the problem and the impossibility of obtaining perfection, the Commission there proceeded to make a detailed and careful analysis of the problem, and applied its judgment and expertise to arrive at a solution. That solution was upheld by the Court of Appeals for the 8th Circuit in *Interstate Power Company* v. *Federal Power Commission*, 236 F. 2d 372, (July 9, 1956)[18], in an opinion which referred to the Commission as:

> "'one of the agencies presumably equipped or informed by experience to deal with a specialized field of knowledge, whose findings within that field carry the authority of an expertness which courts do not possess.' *Universal Camera Corp.* v. *National Labor Relations Board*, 340 U.S. 474, 488. . . . Its 'function is not only to appraise the facts and to draw inferences from them, but also to bring upon the problem an expert judgment.' *United States* v. *Detroit & Cleveland Navigation Co.*, 326 U.S. 236, 241." (236 F. 2d at 385)

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(5) The Courts have never regarded the cost-of-service

[18] Certiorari denied 352 U.S. 967, January 14, 1957.

method for regulation of pipeline rates as being unworkable or unsatisfactory because complex allocations were required, or because such allocations were not susceptible to mathematical exactness. In *Colorado Interstate Gas Co. v. Federal Power Commission*, 324 U.S. 581 (1945), the U. S. Supreme Court stated:

> "Allocation of costs is not a matter for the slide rule. It involves judgment on a myriad of facts. It has no claim to an exact science. Hamilton, Cost as a Standard for Price, 4 Law and Cont. Prob. 321. But neither does the separation of properties which are not in fact separable because they function as an integrated whole." (324 U.S. at 589). . . .
>
> "These circumstances illustrate that considerations of fairness, not mere mathematics, govern the allocation of costs." (324 U. S. at 591)

In a later case, *Colorado Interstate Gas Co. v. Federal Power Commission*, 209 F. 2d 717 (CCA 10, 1953), one of the major issues before the Court was the question as to how joint costs of producing and gathering the wet gas stream to the inlet of the gasoline plants should be allocated as between residue gas and gasoline. The Commission had adopted the relative value method, as presented by the Staff, whereas the pipeline company argued for the adoption of a volumetric method. In affirming the Commission, the Court stated:

> ". . . True, it did say that neither method was entirely satisfactory, but the same could be said with respect to any method which might be proposed. Mathematical exactness in the apportionment of cost is an impossibility. Because a method may have some infirmities does not of itself condemn it as a proper method.[8] It

[8] *Colorado Interstate Gas Company v. Federal Power Commission*, 324 U.S. 581, 65 S. Ct. 829, 89 L. Ed. 1206. (209 F. 2d at 726)

is the duty of the Commission to select that method which in its considered judgment more nearly reaches a just and sound result. The Commission did approve and apply the relative value method, and without extended discussion, we think its conclusion, with respect thereto finds support in the record and is, therefore, approved.

Similarly, with respect to the joint cost allocation problems presented in the instant *Phillips* proceeding, where we are attempting to determine what portion of the joint product well costs should fairly be borne by gas and what portion should fairly be borne by oil, a

number of different alternative methods have been suggested—as to each of which it may fairly be said that there are some advantages and some disadvantages. Our problem is to determine, as among all of those possible alternative methods, which one more closely meets the following basic requirements:

(a) that it assigns a fair share of the joint costs to gas;

(b) that it is a method which can be practicably administered, and that the data required is not unreasonably difficult to obtain and the method itself is not unreasonably cumbersome and time-consuming;

(c) that the results reached, through applying such method, make sense.

In spite of what has been said above, it would not be realistic or fair to suggest here that there are not extremely difficult problems to be solved in working out the application of a cost-of-service approach to producer rate-fixing. However, the resolution of those problems requires the following steps:

(a) reasonably prompt determination by the Commission as to the various criteria, standards and methods to be applied in this area;

(b) the subsequent consideration of techniques which would result in producer records being kept in such a manner that the data required for the application of such determined methods and criteria would thereafter be readily available;

(c) the gradual and continuous accumulation of experience in applying such determined methods and criteria from case to case, this being the normal process by which all regulatory agencies develop the implementation of established general methods and criteria, until finally the problems no longer appear to be unmanageable.

III. Summary of Phillips Operations

Before turning to a discussion of the specific cost-of-service issues involved in this proceeding, it would be appropriate to summarize briefly the nature of Phillips' operations. Phillips was incorporated on June 13, 1917. Its principal executive offices are located at Bartlesville, Oklahoma, and New York City. The company is a diversified, integrated enterprise engaging in virtually every phase

of petroleum industry operations and many related petrochemical activities in the United States (Exh. 296, p. 7). These activities include the exploration for and the development and production of oil and gas, the purchase of oil and gas from other producers, the gathering of natural gas, the processing of natural gas in gasoline plants for the extraction of liquid hydrocarbons, the refining of crude oil and

other petroleum products, the manufacture and sale of various chemicals, the operation of crude oil and refined products pipelines, the sale of refined petroleum products through various types of marketing outlets, and the research for and development of new products (56:7856). Its over-all operations are spread throughout the United States.[14]

In terms of total consolidated balance sheet assets as of December 31, 1955, Phillips was ninth in size among oil companies in the United States (Exh. 296, p. 7). It is one of the largest gas producers in the United States (p. 112 of Phillips' initial brief). However, its annual revenue from sales of natural gas in 1955 were slightly less than 6% of the company's total gross income from all sources (Exh. 222, p. 26). In the test year 1954, Phillips sold 688,811,312 Mcf of natural gas, of which 491,178,953 Mcf, or 71.3 percent of the total, were sales for resale in interstate commerce. A total of 375,690,912 Mcf of gas was produced in that year, and an additional 407,984,210 Mcf was purchased from other producers (Exh. 224).[15]

Phillips' natural gas operations extend from the Gulf Coast to Montana and Wyoming, with its greatest concentration of sales occurring in Texas, Louisiana and Oklahoma. In addition to its natural gas operations, it owns all or part interest in 43 gasoline plants, 27 of which are wholly owned (56:7865).

Of the more than twenty different departments which carry on Phillips' operations, three are directly concerned with the production, handling and sale of natural gas. These are the Natural Gas Department, the Natural Gaso-

[14] Phillips also has operations in several foreign countries, but these operations are, of course, not involved in the instant proceeding.

[15] The difference between the total volume sold, and the somewhat higher total volume produced and purchased, consists of company uses, losses, residue returned to leases, etc., as shown in Exh. 224.

line Department, and the Oil and Gas Production Department. The Natural Gas Department operates all wells producing

dry gas only[16], and all gas gathering systems. The Natural Gasoline Department operates the gasoline plants. The Oil and Gas Production Department operates the 100 percent oil wells, and the joint product wells. The latter include: (a) wells producing both oil and casinghead gas, and (b) wells producing both condensate and condensate gas. In addition, several service departments perform services in connection with natural gas operations (56:7858-60). Out of the total of 375,690,912 Mcf of gas produced by Phillips in 1954, 226,681,178 Mcf was produced in the Natural Gas Department and 149,009,734 Mcf was produced in the Oil and Gas Production Department.

We now turn to a consideration of the specific cost-of-service problems involved in the instant proceeding.

IV. Phillips' Right to Sec. 5(a) Increases Under the Mobile and Sierra Pacific Doctrines

The annual rate increases provided for in Phillips' instant consolidated Sec. 4(e) rate filings (involving jurisdictional contracts which by their terms permitted price revisions under escalation clauses, or for other reasons), amount in the aggregate to $5¼ million—including increases in specific contract rates to levels ranging from as low as only 5.5 cents per Mcf to 13.5 cents per Mcf (with one increase to 17 cents per Mcf).

Phillips' prayer for relief in this proceeding, however, goes much farther than the $5¼ million increase reflected in such Sec. 4(e) dockets. In addition to requesting that the proposed rates contained in its Sec. 4(e) rate filings

[16] Also referred to as gas well gas.

should be found "just and reasonable" and that the Sec. 4(e) proceedings should therefore be terminated, relieving it from any obligation to make refund thereunder, Phillips also makes the following contentions: (a) that its total jurisdictional cost of service is $92,309,438 (Exh. 323, p. 1, line 5); (b) that its present revenues at November 1, 1956 prices (reflecting the consolidated Sec. 4(e) rate increases) are substantially below such cost of service; (c) that in order to eliminate such claimed deficiency Phillips must be allowed gross revenue increases amounting to $44,031,762[17] over and above its revenues at the November 1, 1956 prices (Exh. 324, Schedule I), and must be allowed rates ranging from a maximum of 22.75 cents per Mcf to a minimum of 16.50 cents per Mcf, depending upon delivery conditions.

Phillips accordingly requests the Examiner and the Commission to make a finding under Sec. 5(a) of the Act that unless it is permitted

to recover such rates and revenues, its rates will be so low as to adversely affect the public interest, and to impair its ability to continue its service, within the meaning of the Sec. 5(a) standard laid down by the U. S. Supreme Court in *Federal Power Commission* v. *Sierra Pacific Power Company*, 350 U. S. 348 (1956) (63: 8780-8782). Phillips' ultimate prayer for relief is that in the instant Docket G-1148 proceedings, the Examiner and the Commission should find that its jurisdictional rates are so low that they are not in the public interest, and that the necessary findings and order should therefore be issued permitting Phillips to file rates equal to its total claimed cost of service, it being contended that the specific rates recommended in its Exh. 324 are adequate and appropriate to accomplish this purpose (Phillips' reply brief, pp. 141-142).

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[17] Based on 1954 sales volumes.

It thus appears that if Phillips' total prayer for relief in the instant consolidated proceeding were granted, its annual jurisdictional revenues would be increased in an amount totalling approximately $49 million over and above the level of its revenues prior to the instant Sec. 4(e) rate filings.

It also appears that the $44 million annual increase sought here by Phillips solely on the basis of the requested Sec. 5(a) finding would, if granted, fall upon Phillips' various pipeline customers in the following distribution, based upon 1954 sales volumes:

El Paso	$12,500,109
Michigan-Wisconsin	12,212,496
Panhandle	8,161,586
Northern Natural	2,504,918
Permian Basin Pipe Line Co.	2,591,630
Texas Illinois Natural Gas Pipe Line Co.	1,793,576
Cities Service Gas Co.	1,134,143

The remaining customers would sustain increases under $1 million each (Exh. 363).

It may be noted that with respect to those jurisdictional contracts which, by their terms, do not presently authorize a price change by Phillips, we have a situation falling within the prohibition laid down by the Supreme Court in *United Gas Company* v. *Mobile Gas Corporation*, 350 U. S. 332 (1956), that under the Natural Gas Act a natural gas company has no power to change its contracts unilaterally. It is therefore clear that with respect to those contracts the Phillips rates cannot be changed unless the Commission here determines such contract rates to be so low as to conflict with the public interest—in which

case Phillips may be authorized under Sec. 5(a) to file schedules increasing those rates. Phillips itself recognizes

that this is the only avenue open for a rate increase under such contracts (63:8781-84), and contends that the instant record justifies and requires such a Sec. 5(a) determination.[18]

The standards which must be met in order to warrant such a Sec. 5(a) finding were set forth by the Supreme Court in the *Sierra Pacific* case, *supra*, decided on the same day as the *Mobile* case, and which similarly involved a unilateral rate increase filing. Although the *Sierra Pacific* case arose under Sections 205(e) and 206(a) of the Federal Power Act, those provisions, as noted in the introductory portion of the Court's decision, are substantially identical to Sections 4(e) and 5(a) of the Natural Gas Act. The Court held:

> "The condition precedent to the Commission's exercise of its power under Sec. 206(a) is a finding that the existing rate is 'unjust, unreasonable, unduly discriminatory or preferential.' (350 U. S. at 353)
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> • • • • •
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> "In such circumstances the sole concern of the Commission would seem to be whether the rate is so low as to adversely affect the public interest—as where it might impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory.
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> • • • • •

[18] The conclusion that the Sec. 4(e) route is not available to Phillips in this situation is not affected by the recent decision of the Supreme Court in the *Memphis* case—*United Gas Pipe Line Company* v. *Memphis Light, Gas and Water Division, et al.*, (decision issued December 8, 1958). Unlike the pipeline contracts which were under consideration in the *Memphis* case, the Phillips contracts here contain a specified, fixed price for a term of years, and no general right was reserved to change such fixed price except pursuant to the terms of the specific escalation clauses therein contained.

"Whether under the facts of this case the contract rate is so low as to have an adverse effect on the public interest is of course a question to be determined in the first instance by the Commission." (350 U. S. at 355)

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However, with the exception of the Eastern Seaboard companies (Eastern), the interveners generally take the position in this proceeding that the instant record does not establish that Phillips' contract rates presently in effect are so low as to adversely affect the public interest by impairing its financial ability to continue service; that even in the event it should appear, on the basis of the jurisdictional cost of service determined in this proceeding, that approval merely of the Sec. 4(e) rate increases, and no more, would leave Phillips with a cost of service deficiency, the required findings to justify a Sec. 5(a) order still cannot be made here because Phillips has not been losing money on its gas operations and is not losing money on those operations today.

The Staff's reply brief strongly disagrees with this position, contending that the Phillips contract rates vary so widely, even as between contracts for the same service from the same producing areas, as to patently contravene the public interest, generating and perpetuating undue preference and undue discrimination; that this results in a rate structure completely adverse to the very principles and purposes of the Natural Gas Act; that the *Sierra Pacific* decision, *supra*, clearly recognizes the power of the Commission under Sec. 5(a) to modify contract rates in order to eliminate undue discrimination or preference; that accordingly the Examiner and the Commission should modify Phillips' contract rates in such a way as to eliminate such undue discrimination and preference, and that such modification when effected should permit Phillips

opportunity to obtain revenues from jurisdictional sales sufficient to meet its jurisdictional cost of service as determined in this proceeding.

The important factor to bear in mind here is that we are not in the instant proceeding dealing with a *single*, low-priced contract, as in the *Mobile* and *Sierra Pacific* cases, *supra*, but what is involved here is Phillips' entire jurisdictional rate structure. In the *Mobile* and *Sierra Pacific* cases, where only a single contract was involved, there obviously could be no contention that the failure to permit the pipeline seller to increase its existing rate on that one contract would impair its financial ability to continue its over-all service. In the instant proceeding, however, if the interveners' position were adopted Phillips would be required to absorb the burden of a substantial over-all cost-of-service deficiency, on a system-wide basis. In fact, the application of the intervenors' position in the instant case would produce the following concrete results:

(1) Phillips' rates for the contracts involved in the consolidated Sec. 4(e) dockets would be fixed on the basis of the cost-of-service herein determined. With respect to some of the Sec. 4(e) dockets, where the proposed rate level exceeds the "just and reasonable" rates here determined, this would mean rejection of a portion of the proposed rate increase.

(2) With respect to those contracts not involved in the instant Sec. 4(e) rate filings (hereafter referred to, for purpose of convenience, as the Sec. 5(a) contracts), in those cases where the existing contract rates exceed the "just and reasonable" rates here determined, a rate reduction would be required under the Sec. 5(a) order to be issued in this proceeding.

(3) However, with respect to those Sec. 5(a) contracts where the existing contract rates were, in fact, *lower* than the "just and reasonable" rates here determined, it would follow under the interveners' position that no relief could be provided to Phillips. And Phillips would thus be frozen in a situation where it would be compelled to absorb the resultant over-all system-wide deficiency, until such time as a price revision was authorized under the terms of such contracts—whether as the result of activation of an escalation provision, or a price renegotiation between the parties.

The Phillips reply brief (page 120) correctly characterizes such a situation as follows:

> "These Intervenors would thus convert *Sierra*, which held that the public interest may permit one sale at less than cost, into a decision that requires that all sales in total be at less than cost. Nothing in *Sierra* supports that conclusion."

It is concluded here that such a situation would adversely affect the public interest, in that (a) it would impair Phillips' financial ability to continue to render adequate service; (b) it would so impair the Phillips incentive for continued exploration and development as to jeopardize the continued program for the discovery of new gas reserves, which is essential to meet increasing market requirements; (c) it would result in an unduly discriminatory general rate structure for Phillips. It should further be noted that in the broader context of the entire problem of producer rate regulation now before the Commission, where the Commission is attempting to develop a reasonable, fair and workable system for the fixing of "just and reasonable" producer rates, the adoption of any such position would produce an unfair and discriminatory rate system which would clearly not be in the public interest. As well-stated by Phillips in its initial brief (page 173):

"The finding of a deficiency, without a corresponding finding that rates must be adequate to recover costs, would constitute a finding that it is in the public interest for a natural gas company to provide its services at less than cost. *If cost is to be the standard for rate regulation, a refusal to permit the recovery of costs under the circumstances here presented would be the clearest kind of confiscation.*" (emphasis supplied)

The interveners argue, however, that such a position actually would merely leave Phillips in the same price position it occupied prior to regulation, when it remained bound by the terms of its contracts until they were renegotiated by the parties. But this ignores an important part of the picture prior to regulation, because in the absence of regulation producers were free (a) to raise an existing contract price to the full level permitted under an escalation provision, or to the full level agreed upon in a price renegotiation, without limitation to the "just and reasonable" rate level determined by the Commission; and (b) to negotiate higher price levels in new contracts, without being subject to the possibility that the Commission might in a subsequent Sec. 5(a) proceeding order such new contract price reduced as being in excess of the "just and reasonable" rate. None of these "laissez faire" avenues remain open any longer to the producers since the Supreme Court's *Phillips* decision.

As noted above, the adoption of the interveners' position here would also result in an unduly *discriminatory* general rate structure for Phillips, and this alone is sufficient to warrant its rejection. As noted by the Supreme Court in the *Sierra Pacific* decision, contract rates may be set aside under Sec. 5(a) where they are found to be unduly discriminatory. (350 U.S. at 355).

The U. S. Court of Appeals for the District of Columbia Circuit dealt with this problem in *Mississippi River Fuel Corporation* v. *Federal Power Commission*, 252 F. 2d 619 (1957).[19] In that case United Gas Pipe Line Company sold natural gas to Mississippi River Fuel Corporation under two different contracts—i.e., (1) a 1929 contract, providing for a 45-cent demand charge and a 5-cent commodity charge; and (2) a 1951 contract, providing for a $1.30 demand charge and a 12.5-cent commodity charge. The Commission decision, issued in a Sec. 5(a) proceeding, fixed a single rate of 75-cent demand and 10-cent commodity charge for all sales by United in its Central Rate Zone, including both of these two sales to Mississippi. Mississippi contended, on appeal, that under the Supreme Court decisions in the *Mobile* and *Sierra Pacific* cases, until the Commission determined,

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upon a proper record, that the public interest required abrogation of the two existing Mississippi contracts, the separate contractual basis must be maintained; that the Commission was required to find specifically that the old contract rate of 45-cent demand and 5-cent commodity charge was itself unlawful before a change in that contract rate could be required.

The Court of Appeals rejected this contention and affirmed the order of the Commission on this point, stating:

> ". . . The Commission found . . . that continuance of two rates for the same service at the same point was not in the public interest and would result in unreasonable differences . . . The Commission has power under Section 5 (a) of the Natural Gas Act to determine a just and reasonable rate or contract affecting rates whenever it finds that an existing rate

[19] Certiorari denied 78 S. Ct. 331 (December 16, 1957).

or contract affecting rates is unjust, unreasonable, unduly discriminatory or preferential. In the case at bar the findings of the Commission were that the two rates on the separate contracts 'are not in the public interest', that the continued existence of two rate schedules would constitute 'maintenance of an unreasonable difference', and that compliance with Section 4 of the Act would be effected by a filing by United which would 'eliminate unjust, unreasonable and unduly discriminatory rates to Mississippi' and would apply to Mississippi the same rates applicable to other customers. We think these findings adequately met the statutory prescription for underlying findings in Section 5 (a)." (252 F. 2d at 623)

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"Mississippi argues that the Commission was required by the *Mobile* and *Sierra Pacific* cases, *supra*, to find specifically that the old contract rate of forty-five cents and five cents was itself unlawful before it could order it changed. *Those cases each dealt with a single existing contract.* The Court held that before the Commission could cause such a contract rate to be raised it must make the findings required by the statute. In the case at bar there are two existing contracts, one with a low rate and the other with a high one. The Commission did not find specifically that the low rate was unreasonable, etc. It found that the two contracts, with two rates, were not in the public interest and would maintain an unreasonable difference. It seems to us that the action of the Commission was within the scope of the statute and within the doctrine of the *Mobile* and *Sierra Pacific* cases, even though not within the factual bases of those opinions. We think that in a situation involving two contracts, at different prices, for different portions of

a single service, it is within the power of the Commission to combine the two contracts even though the combination results seemingly in a technical breach of the contractor's or the public's rights under the lower priced of the two contracts." (252 F. 2d at 624-25; emphasis supplied)

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"The whole action was to substitute a single rate for two separate rates found by the Commission to be unduly preferential. The Commission had a *positive duty* under the basic provisions of Section 5 (a) to eliminate preferential discriminations . . ." (252 F. 2d at 626; emphasis supplied)

There can be no doubt that the adoption of the interveners' position here would be far more seriously contrary to the public interest and would maintain a far more unreasonable and unwarranted difference in the Phillips jurisdictional rate structure than the two-contract situation which the Court of Appeals in the above case found to be within the power of the Commission to remedy under the standards of Section 5 (a).

It is therefore concluded that the controlling facts in the instant proceeding satisfy the Section 5 (a) standards as laid down by the Supreme Court in the *Mobile and Sierra Pacific* cases, *supra*, and that accordingly Phillips should be permitted to file rates sufficient to return its total jurisdictional cost of service, as determined in this decision. It should be noted, however, as will be made clear in the order to be entered herein, that with respect to the Section 5 (a) contracts no rates higher than Phillips' existing contract rates will become effective until after Phillips may file new rate schedules for such contracts pur-

suant to the instant order, and until the Commission approves any such new schedules as may thus be filed.

V. Summary of the Different Cost-of-Service Approaches in This Proceeding

Before proceeding to a point-by-point analysis of each of the contested issues in this proceeding, it would be helpful to set

forth at the outset, for purpose of comparison, a concise summary of the general cost-of-service approach followed by each of the parties presenting a comprehensive cost-of-service study in this case. All of these studies were presented on the basis of a 1954 test year.[20]

(1) The Phillips Cost of Service

The cost-of-service presentation relied on by Phillips in this proceeding is embodied in its Exhibits 282, 284 and 323.

In Exh. 282, Phillips' witness Cramer[21] presented the total cost of exploring for and producing crude oil, condensate and raw natural gas by Phillips and its wholly-owned subsidiaries. In addition, he showed the total cost of natural gas purchased by Phillips from others, the total cost of gathering the produced and purchased gas, including the extractable liquid hydrocarbons, and the cost of marketing the produced and purchased gas. Costs which could be associated directly with either crude oil and condensate or with natural gas were charged accord-

[20] At a later stage of the hearing, Phillips' witness Cramer presented a 1956 cost-of-service study (Exh. 303) solely for the purpose of demonstrating that the 1954 cost-of-service relied on by Phillips was, in fact, truly representative of the future (73:10,006).

[21] Senior Auditor in Phillips' Comptroller's Department.

ingly. The great bulk of the total costs, however, were joint costs which could not be associately directly with one product or the other and which accordingly were allocated on various bases. All costs were based upon 1954 as the test year, with certain proposed adjustments which Phillips contends are necessary to make the test year representative of the future. The rate base consisted of the year-end balances, the only adjustment here being the addition of the cost of construction of the Tex-Booster, a field compressor station constructed subsequent to the test year for the sole purpose of maintaining contracted volumes at the level delivered during the test year (60:8459-60).

Production costs (excluding exploration) were first determined by departments. Costs of dry gas production included all costs of the Natural Gas Department. Costs of production from joint product

leases in the Oil and Gas Production Department were allocated between oil and gas on the basis of the "relative cost" method. This method allocates the costs of producing oil and gas together, in proportion to the known costs of producing each separately (60:8461-5).

Exploration costs which can be attributed directly to either the Natural Gas Department or the Oil and Gas Production Department are so charged on Phillips' books. After giving effect to these charges, the balance of the exploration costs was then allocated between and assigned to those departments in proportion to the net investment in producing leaseholds of each department (59:8257-8), resulting in an allocation of 37.69 percent of such remaining exploration costs to the Natural Gas Department (Exh. 282, p. 14, line 2, col. 6).[22] Within the Oil and Gas

[22] After accounting for producing royalties, the amount remaining applicable to producing leases of the Natural Gas Department comprises approximately 34 percent of the total costs attributable to exploration operations (60:8481).

Production Department the sum of direct and allocated exploration costs was further allocated among the separate products in proportion to the total Btu's produced for each of the separate products (60:8464).

The production and exploration costs so determined for all gas produced by Phillips were then added to the purchased gas and gathering costs to determine a total cost for natural gas, including extractable liquid hydrocarbons. Costs associated with liquid hydrocarbons extracted by Phillips were then deducted under a combined volumetric and Btu allocation method. Costs of marketing the residue gas were then added, and the total costs of gas were then divided between jurisdictional and non-jurisdictional business in proportion to the volumes sold (60:8474).

Phillips' witness Cramer used a rate of return of 12 percent applied to year-end investment (60:8482). Federal income taxes were computed at the 52 percent rate, without reflecting the special deductions provided by the tax statutes, and taken advantage of by Phillips, for expensing of intangible drilling costs and percentage depletion (60:8483-4). To the total cost of service, Cramer added $400,000 for regulatory expense (60:8470).

Exh. 282 shows a total cost of service for jurisdictional sales of gas of approximately $82,000,000, reflecting only the claimed purchased gas cost increase adjustments related to the Sec. 4(e) rate filings, but not those relating to the requested Sec. 5(a) increases. This total cost of service would amount, on an average unit cost basis, to 16.707 cents per Mcf (Exh. 282, p. 1, line 5, col. (e)). Exh. 282 further shows revenue from jurisdictional sales of approximately $45,500,000 and a resulting deficiency between revenues and cost of service of approximately $36,500,000. That exhibit, however,

takes into account actual revenue and the Sec. 4(e) pro-

posed revenue increases only through January 1, 1956. Prior to November 1, 1956, Phillips filed additional Sec. 4(e) rate changes in dockets consolidated with this proceeding, providing additional revenues of approximately $2,738,000. The net claimed impact of these further Sec. 4(e) filings upon Phillips' cost of service and revenues is set forth in Exh. 284, and the two exhibits combined show a net claimed deficiency between revenues and cost of service of approximately $35,250,000.

It is to be borne in mind, however, that in Exhs. 282 and 284 Phillips reflected a claimed purchased gas cost increase adjustment computed only on the basis of its Sec. 4(e) filings. In its final presentation in this proceeding Phillips relies upon Exh. 323, showing a total jurisdictional cost of service of $92,309,438, computed on the basis of reflecting the claimed purchased gas cost increase which Phillips claims it would incur if it were allowed to recover its entire calculated jurisdictional cost of service, as a result of the Commission making the Sec. 5(a) findings here requested by Phillips. This total jurisdictional cost of service in the amount of $92,309,438 would amount to an average unit cost of 18.793 cents per Mcf (Exh. 323, p. 1, line 5, col. 3; Phillips, initial brief, p. 149).

(2) The Staff Cost of Service

The Staff did not determine costs for casinghead and condensate gas. Instead, the Staff in Exhs. 208 and 212, prepared by Staff witness Vaught, computed unit costs for dry gas by areas, and "imputed" the unit cost of producing dry gas in the Panhandle-Hugoton field to casinghead and condensate gas produced by Phillips' Oil and Gas Production Department in *all* areas. As a result, the Staff study does not constitute an allocation of total cost.

The Staff computed unit dry gas costs as follows: Staff costs were based upon recorded amounts for the year

1954, without reflecting Phillips' claimed adjustments for "known changes." The Staff accepted the direct charges to the Natural Gas Department for exploration as shown on Phillips' books (50:7172-3), but rejected the method used on Phillips' books for allocating the balance of exploration costs between departments on the basis of net investment in producing leaseholds. Instead, the Staff assigned 15 percent of the remaining exploration costs to the Natural Gas Department (44:6496). The exploration costs thus allocated to the Natural Gas Department were then included in the computation of the unit dry gas costs imputed to casinghead gas.

The dry gas costs thus calculated, including purchased gas and gathering costs, were allocated between natural gas and liquid hydro-

carbons extracted by Phillips on a relative value basis (45:6571-5), using settlement figures shown on Phillips' books for gas purchased by Phillips as the relative value between gas and liquids (49:7017). A rate of return of 9 percent was applied to a rate base consisting of an average of beginning and ending balances for the year 1954 (Exh. 208, Sched. 5, Sheet 1). With respect to the federal income tax component, the Staff's initial brief (pp. 113-121) takes the position that the computation should be made on the basis of Phillips' actual tax liability, reflecting both the statutory depletion and intangible well drilling allowances.

On this basis, the Staff concludes that Phillips is entitled to a total jurisdictional cost of service of $42,024,180 (p. 148 of Staff's initial brief) and this would amount to an average unit cost of service of 8.55 cents per Mcf.[23]

[23] $42,024,180, divided by 1954 jurisdictional sales volume of 491,178,953 Mcf.

(3) The Eastern Seaboard Intervenors' Cost of Service

The cost-of-service study presented by witness Caplan[24] on behalf of the Eastern Seaboard group appears in Exh. 388. Caplan used Cramer's relative cost method (but with some changes) for the purpose of allocating joint product well production cost in the Oil and Gas Production Department between gas and oil (100:13217). Direct exploration charges to departments by Phillips were accepted by Caplan, but remaining exploration costs were allocated directly between oil and gas on the basis of what he termed the "reserves added realization" method (RAR), without any preliminary allocation of such costs as between the Natural Gas Department and the Oil and Gas Production Department (Exh. 388, Sched. 28). Caplan then allocated total cost of exploration, production, gas purchases and gathering costs between natural gas and natural gas liquids extracted on the basis of what he termed a "modified sales realization" method (101:13303). Return was computed using a rate base consisting of an average of beginning and ending investment balances (Exh. 388, Sched. 31). No witness for the Eastern Seaboard group recommended a specific rate of return, but

for illustrative purposes only, Caplan showed the results of his study using three different rates of return of 6 percent, 9 percent, and 12 percent (Exh. 388, Sched. 40). In computing the income tax component, Caplan reflected the statutory depletion allowance, but did not reflect the expensing of intangible drilling costs (101:13305). He also used a higher interest expense deduction in computing income taxes than that used by Phillips (101:13304).

[24] Dr. Benjamin Caplan, formerly a member of the Staff of the Council of Economic Advisers in the Executive Office of the President, and subsequently Economic Adviser to the Economic Stabilization Agency. Dr. Caplan is presently associated with the firm of Boni, Watkins, Jason and Company in New York City, as a senior consultant.

On the basis outlined above, Caplan derived a total cost of service for jurisdictional sales of gas amounting to $55,046,180, or an average unit cost of 11.207 cents per Mcf with a 9 percent rate of return (Exh. 388, Sched. 40, p. 2, Col. (F), lines 6 and 7); and a total cost of service of $60,489,481, or an average unit cost of service of 12.315 cents per Mcf with a 12 percent rate of return (Exh. 388, Sched. 40, p. 3).

(4) The Wisconsin Cost of Service

The cost-of-service study presented by witness Van Scoyoc,[25] on behalf of the State of Wisconsin, Public Service Commission of Wisconsin and City of Detroit, Michigan, appears in Exh. 389. Production costs of Phillips' Oil and Gas Production Department were allocated between oil and gas on the basis of what Van Scoyoc terms the "separate products cost" method (Exh. 389, Sched. 11)—roughly similar to Cramer's "relative cost" method. Direct exploration charges to departments were not accepted by Van Scoyoc and were added back to the totals to be allocated (119:16064-5). Allocation of total, system-wide exploration costs between natural gas and crude oil and condensate was made in direct proportion to the net revenue of the various products, using actual income for oil and condensate liquids and cost of service as the income for gas before deducting expenses to arrive at net revenue (101:13386-7; 119:16061). Joint costs between natural gas and natural gas liquids were allocated on the basis of what Van Scoyoc termed the "single marketable products basis" (101:13359-64). Since the allocated cost of service for gas was used as the basis

[25] Melwood W. Van Scoyoc, formerly a member of the Federal Power Commission staff from 1938-1954, serving as Assistant Chief of the Bureau of Accounts, Finance and Rates from 1946-54—presently engaged in consulting work in the public utility field.

of allocation with respect to both exploration and natural gas liquids, the methods used by Van Scoyoc necessarily required multiple trials before arriving at the final figures (119:16062-4) Wisconsin takes the position that *average* year rate base should be used.[26] The rate of return em-

ployed was an assumed 7¾ percent (101:13369). In computing federal income taxes, both the statutory depletion and intangible well drilling allowances were reflected as deductions (101:13398).

On the basis above outlined, Van Scoyoc arrived at a total cost of service for jurisdictional sales of gas amounting to $48,647,832, or an average unit cost of 9.904 cents per Mcf.

In summary, it is of interest to note here, for purpose of comparison, that the four comprehensive cost-of-service studies presented in this proceeding produced the following results:

Party		Total Cost of Service for Jurisdictional Sales of Gas	Average Unit Cost per Mcf
Phillips		$92,309,438	18.793¢
FPC Staff		$42,024,180	8.55¢
Eastern	(at 9% rate of return)	$55,046,180	11.207¢
	(at 12% rate of return)	$60,489,481	12.315¢
Wisconsin		$48,647,832	9.904¢

This decision does not adopt, without modification, the total cost-of-service as presented by any one of the parties. However, for purpose of convenience, the cost-of-service here derived uses the Eastern cost-of-service study (Exh. 388) as its point of departure. Wherever there is a departure from the Eastern position on a given item, the

[26] However, Van Scoyoc, for comparative purposes only, used Cramer's year end figures in his Exh. 389 (Wisconsin initial brief, pp. 5-6).

appropriate recalculation, if deemed necessary for clarity, is set forth in a table contained in the Appendix at the end of this decision. In addition, wherever a given schedule in Exh. 388 contains figures which are affected by any such recalculations, that schedule has been reworked in an Appendix table.

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X. Allocation of Exploration Costs—Alternative Methods Considered in This Proceeding

The determination of Phillips' exploration costs[43] constitutes one of the most important issues in our entire cost-of-service study. The impact of this particular question is demonstrated by the fact that Phillips' total jurisdictional exploration costs (including exploration expenses, plus exploration return and related Federal income taxes) as computed by Cramer amount to $23,372,077, or 28.48 percent of Phillips' claimed (Exh. 282) total jurisdictional cost of service ((Exh. 388, Sched. 1-A, cols. (H) & (I), lines 8, plus 10, plus 13.)) Total exploration *expenses* (not including exploration return and taxes) amount to $15,016,511, or 18.3 percent of the total jurisdictional cost of service (Exh. 388, Sched. 1-A, line 8).

Although a minor portion of Phillips' exploration costs can be attributed directly to its Natural Gas Department, and therefore requires no allocation, the bulk of exploratory costs are by their inherent nature joint costs which must be allocated as between gas and oil. A substantial portion of the record and briefs in this proceeding was, ac-

[43] Throughout this discussion it will be helpful to bear in mind that where the term "exploration costs" is used, it includes exploration return and related taxes. Where the term "exploration expense" is used, these items are not included.

cordingly directed to the issue as to what allocation method should be adopted for this purpose.

In addition to the Staff approach, which has already been discussed, alternative methods for the allocation of exploration costs were presented by Phillips, Wisconsin, Pacific, Southern and Eastern. The following table[44] indicates the alternative methods proposed and the percentage of exploration costs allocable to gas under each:

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Allocation of Exploration Costs

Party	Allocation Basis	Allocated to Gas
Phillips	Net leasehold—Btu	61.88 percent
Wisconsin	Net revenue	20.82 percent
Pacific	Net contribution to earnings	23.98 percent
Southern	Successful wells	25.79 percent
Eastern	Reserves added realization (RAR)	30.46 percent

Because of the totally different approach employed by the Staff, as noted above, it is difficult to make a meaningful comparison of the Staff figures in this regard with those developed by the other parties. However, it is of some interest to note here that the Staff's initial brief (pg. 39) summarizes the effect of its method as allocating approximately $16,000,000 to natural gas exploration operations in the test year, and alleges that the comparable Phillips figure (based on Exh. 283) was approximately $34,000,000.[45]

Before proceeding to a detailed discussion of these alternative allocation methods, reference will be made to a few preliminary matters. No issue is raised as to the total amount of Phillips' exploration expenses for the

[44] Southern brief, page 25.

[45] These two figures, as cited by the Staff, represent jurisdictional exploration costs only (Staff's initial brief, Exh. A, sheet 2), whereas the exploration cost ratios set forth above reflect the exploration cost situation prior to the allocating out of liquid extraction costs and the costs attributable to non-jurisdictional gas sales.

test year 1954, calculated by Phillips at $47,474,039.[46] In addition, all parties have treated such exploration expenses as current charges, rather than as capital charges to be amortized.[47]

Southern complains of the fact that under the Phillips cost-of-service exploration costs are distributed on a pro-rata basis to all jurisdictional

sales, and are therefore equally reflected in the rates to be paid by all Phillips' customers without regard to whether deliveries to such customers consisted of gas actually produced by Phillips itself, or purchased by Phillips from other producers.[48] Southern objects to the fact that customers such as itself on the western part of the Phillips system would thus be required to pay in their rates a pro-rata portion of Phillips' total exploration costs, in spite of the fact that most of those costs were actually expended in southern and offshore Louisiana, and despite the fact that a relatively high portion of the gas delivered by Phillips from the Permian Basin area, which constitutes a major source of supply for its western system, consists of purchased gas.

It is concluded that the above position is without merit for the following reasons:

(1) The exploration activities carried out by Phillips in any major area are of ultimate long-range benefit and

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[46] The only differences were that the Staff figure was lower by $143,000, due primarily to its exclusion of Phillips' subsidiaries from the cost of service. In addition, with respect to that portion of the total figure representing land, geological and geophysical expenses, it has been noted earlier that Eastern witness Caplan took the developmental portion of this item out of "exploration expenses" and transferred it to "indirect lease expenses."

[47] Vaught, 50:7182-4, Caplan, 100:13,257; Cramer, 84:11,320; Wisconsin witness Colbert, 112:14896-8.

[48] In the test year 1954 approximately 52 percent of Phillips' gas supply was purchased by it from other producers (Exh. 224).

importance in connection with the problem of satisfying the supply requirements of its entire system.

(2) The situation complained of by Southern is balanced out by the fact that the Phillips purchased gas costs for that purchased gas which is actually delivered to its western system are also distributed on a pro-rata basis to customers in other parts of the Phillips system.

(3) The Southern position, if carried out to the ultimate degree, would require that the rates paid by any given Phillips customer should not reflect any costs not directly related to the gas actually delivered to such customer—including not only exploration costs, but production costs and other costs as well. The net result of such a position would be to require the making of multiple, separate cost-of-service studies, on a contract-by-contract basis. Such a procedure would be highly impracticable and undesirable, and is completely unnecessary to the determination of a fair and reasonable result in the public interest.

In response to the Phillips contentions as to the level of exploration cost allowance allegedly required to provide it with the necessary incentive for continued exploration and development, the briefs filed by Pacific and other interveners have stressed the fact that there is no assurance that any exploration funds made available to Phillips through rates approved in this proceeding will necessarily benefit its interstate gas customers; that any new reserves discovered as a result of

such exploration operations might be diverted by Phillips to intrastate uses, or that such funds could be used by Phillips for overseas exploration.[49]

[49] Phillips carries on a substantial level of exploration activity in other countries.

It seems clear, however, that if Phillips' jurisdictional rates are to be determined on the basis of a test year cost-of-service, then in the absence of compelling reasons to the contrary there must be reflected in such cost-of-service Phillips' actual test-year exploration costs, adjusted to reflect the appropriate allocation to non-jurisdictional sales.[50] Mere speculation that Phillips in future years could, if it so desired, devote a larger portion of its exploration expenditures to foreign operations, or could resell a larger percentage of its gas supply in intrastate commerce, cannot be regarded as a basis for departing from this general principle in the instant proceeding. Of course, if such a major change in the direction of Phillips' test-year operations should develop in the future, the Commission would always have the power to institute a new Sec. 5(a) rate investigation, in which a new cost-of-service study would then be developed reflecting such changes.

In addition to the above, it is relevant to note here that the Phillips policy witness in this proceeding, Mr. Learned, testified that the entire exploration allowance ultimately approved by the Commission in the cost of service to be adopted in this proceeding, including return allowed on exploration investment, would be used by Phillips:

> "... in an exploration and development program which would have for its purpose the finding, developing and marketing of sufficient new gas supplies to enable Phillips to maintain the service which it is now performing." (62:8678, 8680 and 8682)

Before proceeding now to discuss the various allocation methods which have here been proposed for the allocation of exploration costs, it will be helpful, at the outset, to indicate the breakdown of items which are included in ex-

[50] The procedure for making the allocation to non-jurisdictional sales, which is not the subject of dispute in this proceeding, will be outlined at a later point.

ploration expense and exploration investment. Cramer's Exh. 282, pg. 14, lists exploration expense as $28,109,927.27 (line 6). This total figure includes, among other things, the following items (Exh. 282, pg. 16):

Undeveloped lease rentals [51] .....$4,994,085 (line 5).
Expired and surrendered leases ...$9,479,898 (line 12).

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Dry holes exploration .....$11,306,964 (line 10).
Dry hole contribution .....$ 2,025,395 (line 11).

It is thus clear that the total exploration expense represents largely the costs of unsuccessful exploration—i.e., dry hole expense, and the expense for expired and surrendered leases.

Cramer's gross exploration investment figure was $98,992,143 (Exh. 282, pg. 15, Col. 8, line 12). Out of this total, $76,347,909 represented investment in undeveloped leases (pg. 15, Col. 8, line 9).

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B. *Year-End vs. Average Rate Base*

The only major issue with respect to rate base is whether it should be determined on the basis of year-end investment or upon the average of the test year. Phillips used the year-end investment. The Staff and interveners Eastern, Wisconsin, and Southern averaged the beginning and end of the test year, to obtain an average rate base. The difference between these two methods produces an impact of over $1,500,000 in the total cost of service.

[51] "Undeveloped lease rentals" represent delay rental expense charges paid in order to hold the undeveloped leaseholds (79:10,715-16).

The Staff and intervener argument against year-end rate base is that it weighs in for a full year the cost of plant additions made during the year, whereas the revenues and expenses against which the investment has been matched are not adjusted to reflect the operations of the facilities installed on a full year basis (101: 13,292-94; 13,370). Both Eastern and the Staff contend that the use of average rate base is consistent with prior Commission practice. In support of this contention, they cite a number of earlier Commission decisions in which average rate base was in fact used, but where the question did not develop as a contested issue and accordingly was not the subject of any analysis in the Commission decision.

In support of its position that year-end investment should be used, Phillips argues that its Exhibit 237 demonstrates that, both on an absolute basis and on the basis of net investment per unit sold, the Phillips net investment has been increasing substantially each year. It is accordingly contended that it is year-end investment, rather than average rate base, which is more representative of the future. The Phillips reply brief (p. 95, footnote 2 cites a number of Commission decisions (all prior to 1949) in which year-end investment was used. However, most of these decisions were issued in settlement cases, and none included any discussion of the problem.

Generally speaking, it would appear to be desirable to use average rate base, *provided* that the test-year relationship between average rate base and actual annual volumes of sale may be regarded as representative of the future. This was, in fact, the basic principle or criterion laid down by the Commission in two important cases where Commission policy on this issue was discussed in detail—i.e., Op. No. 258, *In the Matter of United Fuel Gas Company,* 12 F.P.C. 251 (1953); and *In the Matter of Otter Tail Power Company,* 8 F.P.C. 393 (1949).

In these two cases the Commission concluded, on the basis of the evidence there presented, that the test-year relationship between these two factors was a representative one, and accordingly average rate base was used.

In the *United Fuel Gas Company* case the Commission stated:

> "We do not believe that a rate base computed as of one point in time is necessarily a proper measure of the investment which produced revenues over a period of time or which will be required to produce a volume of annual sales by a company which has experienced and still anticipates growth at the rate recorded for United Fuel. Sales are made by means of a plant which changes frequently. A precise measure of the plant used to produce a specific annual sales volume would be an average of the daily plant balances for the year. Such precision is unnecessary in the ordinary case where additions are relatively small or evenly spaced, hence we have frequently used average monthly balances to derive an approximation of the average continuous plant investment during a test period. In the instant case, it appears that United Fuel made additions to plant uniformly throughout the year, and, consequently, an average of the beginning and ending plant balances gives a reasonable approximation of the average continuous plant balance." (12 F.P.C. 255-256)

However, after thus setting forth the general principle to be followed in the absence of unusual conditions requiring a different treatment, the Commission proceeded to state the proviso in the following language:

> "Underlying our method of matching investment with revenues, there is the implicit assumption that the pat-

> tern of the period chosen is representative of the future—that the size of the plant investment in a particular period is related to sales of such period and that this relationship is relatively constant, and will hold true for the future." (12 F.P.C. 256)

In the *United Fuel* case the proviso just quoted was not applicable because, as there noted by the Commission, it appeared that United Fuel's historic growth in total sales had closely paralleled its growth in plant. It further appeared that United Fuel intended to expand its system, and that it anticipated a steady growth in sales volumes. The Commission noted that if this historic trend continued, investment requirements per unit of sales might be expected to decline, rather than to increase over test period requirements—since the record indicated that average plant investment per annual sales volumes had gone down from 59 cents per Mcf in 1947 to 52 cents per Mcf

in 1951. It was thus apparent that in the light of this trend the ratio of average rate base to annual sales volumes would be even lower in subsequent years than during the test period, and it was accordingly inappropriate to match test-year volume of sales with year-end rate base, which was even higher than average rate base for that year.

Similarly, in the *Otter Tail Power Company* case, *supra*, there was no contention that investment requirements per unit of sales were increasing. The Commission therefore concluded that under the facts there noted the use of the averaging method was appropriate. However, the Commission stated:

> "In other cases depending upon the particular facts, we have considered the year-end balances as well as the yearly average balances for the test year. *It has been*

our aim to use the method which would more clearly represent the future experience as far as that could be determined." (8 F.P.C. 401 emphasis supplied)

An examination of the evidence in the instant case demonstrates that the relationship between Phillips' 1954 average investment and the 1954 actual annual volume of sales was *not*, in fact, representative of the future, since it appears that the ratio of net plant investment required per million Btu's produced and sold has been steadily increasing from 36.79 cents in 1951 to approximately 56.94 cents in 1956. (Exh. 237; 80: 10,797)[121] It thus appears that in order to maintain the same level of production which was experienced in 1954 a constantly higher investment is required. (80: 10,797-99)

Since it therefore seems clear that Phillips' 1954 relationship of sales volume to average rate base is not a representative one for the future, the problem here is to determine or develop a different relationship which would, in fact, be reasonably representative of the ratio between average rate base and actual annual volume of sales expected to pertain for 1955, 1956, and subsequent years. Accordingly, in considering the propriety of Phillips' use of 1954 year-end rate base and 1954 actual annual volume of sales in this case, our attention should be directed to whether the resultant ratio would be comparable to and in line with the relationship of average rate base to actual annual volume of sales experienced in 1955, 1956 and subsequent years.

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[121] In fact, with the sole exception of the year 1950 when a very slight drop was experienced, the net plant investment per million Btu's sold has increased steadily in every year commencing with 1946. It is recognized that the Exh. 237 figures are based upon total investment including oil and gas, and total sales including both products. However, this does not affect the point made here.

The answer to this factual question can be determined in a rough way, which is sufficient for our present purpose, by reference to the data contained in Exh. 237. Calculations based upon this data indicate that Phillips' 1955 *average* net plant investment per million Btu's sold[122] was 51.61 cents; that the 1956 figure was 54.60 cents; and that if the trend indicated by Exh. 237 were to continue, it could be expected that even higher ratios would be incurred for 1957 and the years immediately following. By contrast, the 1954 test year *average* net plant investment per million Btu's sold[123] was only 48.96 cents—a figure which clearly is *not* representative of the ratio prevailing for 1955 and 1956 and which can be expected to prevail for the ensuing years.

On the other hand, the 1954 *year-end* investment per million Btu's sold, being a ratio comparable to Phillips instant proposal to use 1954 year-end investment plus 1954 actual revenues, amounted to 51.81 cents. This figure is practically the same as the 1955 *average* net plant investment per million Btu's sold which amounted to 51.61 cents, and is, in fact, *lower* than the 1956 *average* net plant investment per million Btu's sold amounting to 54.60 cents. It is therefore concluded that the use of 1954 *year-end* investment, plus 1954 actual revenue, in the instant case *does* produce a result which can be regarded as reasonably representative of the relationship between average rate base and actual annual volume of sales for 1955, 1956 and ensuing years; that this is not true of the relationship between 1954 *average* rate

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[122] Obtained by adding 1954 and 1955 year-end investment, and dividing by two; then relating the resultant figure to the 1955 volume of production sold.

[123] Involving a ratio comparable to the Staff and interveners' proposal to use 1954 average rate base plus 1954 actual revenues.

base and 1954 actual revenues; that accordingly the Phillips rate base in the instant case should be computed on the basis of year-end rate base.[124]

In reaching this conclusion, it is of interest to note the position taken in similar situations by State regulatory commissions in recent years. *In the Matter of Potomac Electric Power Company*, 8 PUR 3rd 76 (1955) was a rate case before the District of Columbia Public Utilities Commission. The Commission noted that the uncontroverted evidence submitted by the company indicated that it had been and would be compelled to make extensive additions to its facilities to keep pace with the constantly growing demand for power within its service

area, and that increases in earnings from new facilities had not kept pace with the related increases in investment. Under these circumstances, the company contended that instead of using average investment for the preceding year as a rate base, the net investment at the end of the year should be adopted as the base for the purpose of determining its allowable earnings. The D. C. Commission agreed with this contention, stating:

> Since rate making is geared to the future, from a theoretical standpoint both the investment and revenue figures should be projected. Because of the serious elements of speculation and uncertainty which often are injected by such an attempt at projection, however, it has been a usual practice to employ actual or adjusted past figures for both investment and revenues. This is justified normally by the fact that increases in plant may be expected to result in approximately

[124] For recalculation of the Phillips rate base on the basis of year-end investment, see Appendix Table 2.

proportional increases in revenues so that an appropriate allowance for future investment is automatically provided. So long as this expectation is regarded as sound it is essential, of course, that corresponding figures be used for revenues and rate base, or, in other words, that the rate base represent the plant which produce the revenues for the period taken. Since the investment in plant varies throughout any revenue period, this is accomplished by taking a weighted net average during the period.

"The premise that increases in plant produce an approximately proportionate increase in revenues loses validity, however, when large new investments must be made at prices sharply higher than the average cost of existing plant. To provide a rough counter-balance for this 'attrition' in earnings a considerable number of regulatory bodies have permitted the use of 'end of period' rather than 'weighted average' rate bases in appropriate cases. . . . For this same reason we have concluded that it is reasonable to adopt 'end of year' rate base in the present proceeding. In so concluding, however, we must emphasize that it is a deviation from what might be regarded as the proper standard under more normal conditions, and our action is not to be construed as furnishing a precedent in the case of other companies not faced with the same combination of circumstances or in the case of PEPCO itself when the present extraordinary situation shall have been altered." (8 PUR 3rd, at 89-90)

In the Matter of Florida Power Corporation, 99 PUR (NS) 129 (1953) was a rate case before the Florida Railroad and Public Utilities Commission. The Commission held:

"In normal times and under stable conditions the amount of revenue required to produce a fair rate of return can generally be calculated accurately and equitably upon the average and not the year-end balances of the test year. On the other hand, where a utility is in the throes of

unusual growth and confronted at the same time with constantly increasing investment and operating costs, conventional notions of rate making must be adjusted to the circumstances and this is especially true where net earnings fail to keep pace with heavy additions made and to be made in plant investment. Where there is little fluctuation in a utility's investment accounts from the beginning of the year to the end of the year, we believe that the rate base should be predicated upon the net average investment for the test period. We have followed that method consistently for many years and will continue to do so whenever and wherever the investment accounts disclose nothing more than a normal growth. In the present case, a net average investment rate base for the test year 1952 would be $76,000,000 in round figures whereas the utility at the end of 1952 had more than $95,000,000 invested in electric plant. If we use the average investment for the year 1952 in determining the rate base, we would assume an investment level that is more than a year old. Such a rate base would bear no relationship to the actual conditions as they now exist. There seems to be only one sound objection to the use of the year-end rate base and that is that some additional revenues must be ascribed to plant additions; however, this would be largely offset by the factors of additional depreciation, taxes, and expenses, so that there is little,

if any, danger of excessive compensation. Under present conditions, as disclosed by the record herein, we conclude that the year-end rate base is more realistic than the average investment rate base. Inasmuch as we are here fixing rates for the present and for a reasonable time in the future, we should not use an investment figure that is already more than a year old. During a period of rapidly rising prices and plant expansion, it is difficult, in proceedings of this nature, to determine an adequate and reasonable rate base. We must be fair to the public and exercise our rate-making power in such a way that the public is protected against exorbitant or unreasonably high rates. At the same time, the interest of the utility, and those who invest in its securities, must also be protected against noncompensatory rates." (99 PUR (NS), at 134-135)[125]

XIII — Adjustments to Test Year

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B. *The Contention that Phillips' Investment in the San Juan Facilities Should be Excluded from Rate Base*

As already noted in detail in connection with our discussion of Caplan's royalty adjustment under his RAR method, Phillips transferred its San Juan properties to Pacific Northwest Pipeline Corpora-

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tion in November 1955. Interveners Southern and Wisconsin contend that this transfer constituted a "known change" which should be reflected as a downward adjust-

[125] Similarly, see *Board of Supervisors* v. *Virginia Electric and Power Co.*, 196 Va. 1102, 87 SE 2nd 139, 150; *Western Light and Telephone Co.*, 17 PUR 3rd 422, 425.

ment to Phillips' test year rate base. (Southern initial brief, pp. 11-12; Wisconsin reply brief, p. 11). It may be noted that the total San Juan investment, amounting to $11,537,444, includes San Juan exploration assets in the amount of $3,106,686. (Exh. 346, sheet 3) This latter item has already been allocated out of Phillips' jurisdictional cost of service under the Caplan RAR method, which has here been adopted, since he allocated an appropriate portion of total exploration investment to royalty gas. If the position here advanced by Southern and Wisconsin were adopted, it would require a further reduction of the Caplan-computed rate base by slightly over $8,000,000, representing Phillips' net investment in San Juan producing leases. (Ex. 346, sheet 3)

The fallacy in the interveners' position here is that it treats the situation as one in which San Juan acreage was disposed of in 1955, and in which no additional leaseholds took their place. This however, was not the case. Phillips' policy witness Learned testified, in this connection, with reference to the 1955 sale of the San Juan acreage:

> "I can only say that we have probably already considerably more than reinvested the funds that came from that sale. They were a reasonably small amount and the override has been very small up to date. I don't think there is a question in the world but what they have already been reinvested." (92: 12,460-61)

In addition, Phillips witness Cramer testified:

> "All the way through I have been concerned about whether or not the cost of service study which I have prepared in connection with the year 1954, and as an adjustment that I had made, and including the investment in the San Juan leases and expenses and revenues that we are now talking about, of whether

or not that was truly representative of the future.

"I was aware that we had—although we had sold these properties that we had acquired other properties, and if I were going to take one out then I probably would need to consider including others that had been acquired, so that is . . ."

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"That was the reason that I was anxious to prepare an experimental test year for the year 1956 which has the San Juan properties out so far as the investment and expenses. It has all of the other changes that have

occurred, including the small drop in the direct dry hole expense that Mr. Lamb referred to yesterday, and *as a result of that experimental test year, and knowing the results thereof, I concluded that the cost of service study as I had prepared it, including the adjustments and including San Juan, was representative of the future as tested by the year 1956.*" (73: 10,006, lines 2-23; emphasis supplied)

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"Again, with respect to the San Juan, the company is constantly acquiring additional properties and maybe from time to time relinquishing the ownership of others, and knowing the magnitude of the additional properties that had been acquired after the year 1954 it seemed to me that it was unnecessary to make an adjustment with respect to San Juan.

"Now, for example, the natural gas departments rate base, or net investment at the end of 1954, was approximately 130 million dollars, but after removing the San Juan properties that were adjusted out in

November of 1955, and the additions to the gas department's properties in the year 1955, not only replaced the San Juan, dollar for dollar, but added some seven million dollars to the net investment over and above the depreciation and depletion that was recorded in the year, also." (73: 10,007, lines 11-25)

Southern notes the fact that the San Juan properties, which were included in the Phillips rate base for the test year in the amount of approximately $11,500,000, actually produced only $141,968 of jurisdictional revenues during that year. The Southern brief suggests that it would be unfair to include these properties in Phillips' rate base in view of the fact that the test year revenues received therefrom were insignificant, and that the properties were disposed of by Phillips as soon as they commenced to earn substantial revenues. The same argument, of course, could be made for the exclusion from Phillips' test year rate base of other undeveloped leaseholds which produced little or no revenue during the test period. However, this argument is not regarded as impressive, since it is not unusual for a substantial time lag to occur before potentially valuable leaseholds acquired by a producer in the normal course of business commence to produce and earn revenue. If this practice were not followed, the continual development of new reserves which is of such importance to consumers would be seriously hampered.

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In the "spiral escalation" contract situation Phillips purchases *dry gas* from certain producer-suppliers under contracts providing a fixed rate. However, these contracts contain spiral escalation clauses which are triggered by the going into effect of a similar spiral escalation clause in

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Phillips' resale contract with Michigan Wisconsin (Phillips FPC Gas Rate Schedule No. 4, *supra*).

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XIX. The Phillips Presentation Under the Heading of "The Consumers' Need for Gas and the Producers' Increasing Problem of Supply"

Phillips devoted a great amount of time in the hearing and in its instant briefs[175] to the painting of a pessimistic picture concerning the economic, geological and engineering aspects of our national gas supply. This presentation stressed the following points:

(1) The rapidly increasing demand for natural gas, and the alleged failure of discoveries to keep pace with such demand.

(2) The increasing depth of drilling resulting in increasing drilling costs.

(3) Rising exploration expenditures.

(4) Decreasing discoveries per million feet of hole drilled.

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(5) Declining ratio of net earnings to net investment in total gas and oil production.

(6) Increasing gas-oil ratios, making the producer more dependent than formerly upon income from gas.

Among other things, the Phillips presentation on these subjects would appear to be designed as a justification for its proposed allocation of approximately 60 percent

[175] Initial brief, pp. 8-41; reply brief, pp. 4-27.

of its total exploration costs to natural gas, as distinguished from oil—this being an allocation as to which Phillips itself states:

> "At first glance, the total amount charged to gas and natural gas liquids may appear large." (initial brief, p. 112)

The presentation appears also to have been advanced as a justification for the high rate of return here proposed by Phillips.

In general, the evidence presented on these subjects seems calculated to create the impression that the future prospects for finding necessary supplies of natural gas are so unpromising that the consumers must pay for an extremely high portion of exploration costs, as a sort of incentive or bonus necessary to call forth natural gas supplies in quantities sufficient to meet projected demands. Thus the Phillips exhibits and testimony in this connection embody complaints about the hazards of and the meager returns from exploration and development, and they attempt to lay the groundwork for the imposition of relatively high cost burdens upon the consumer by suggesting that if we are to meet future demands for natural gas "enormous discovery rates must be reached and maintained".[176]

We now turn to a point-by-point examination of the Phillips presentation on these subjects. It may be noted at the outset that Eastern presented a detailed rebuttal to this presentation through its witness, Dr. Alfred Kahn.[177]

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[176] Phillips witness Turner, 65: 8918.

[177] Professor of Economics at Cornell University, and a member of the Cornell faculty for the past ten years. Dr. Kahn served as Senior Staff Member on the President's Council of Economic Advisers in the year 1955-1956, acting as adviser on natural gas legislation. He is also a special consultant to the New York firm of Boni, Watkins, Jason & Company.

A. *The Phillips Contention as to the Rapidly Increasing Demand for Natural Gas, and the Alleged Failure of Discoveries to Keep Pace with Such Demand.*

Phillips witness Turner testified that in spite of the continued growth of proved gas reserves, enormous gas demands have caused the national life index, or reserves-production ratio,[178] to decline without interruption from 32.5 years at the end of 1946, to 22.1 years at the beginning of 1955, and to 21.8 years at the end of 1956. (Exh. 251, Panel A; Exh. 390, Sched. 1, 57; 8062; 102: 13,445)

It should be noted at the outset the concept of a 22-year life index does not mean that our national gas supply will be exhausted 22 years from now, since it does not take into consideration the reserves of natural gas to be found in the future, which will constitute by far the greater portion of our future supplies. Dr. Kahn testified:

> "Such uses of life-index figures are usually accompanied by statements . . . to the effect that by far the greater proportion of future supplies will come not from presently estimated proved reserves, but from supplies yet to be found and proved in the future. To the extent that industry sources minimize the significance of the life-index ratios, therefore, they do so not on the ground that the ratio is excessively reassuring, because of its failure to take into account the period of deliverability, but on the ground that it places excessive emphasis on the relatively small portion of total future supplies that has so far been found." (118; 15,914, line 19—15,915, line 5)

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[178] The mathematical ratio of current total reserves, to current annual volume of production.

Similarly, a report of the National Petroleum Council to the Department of the Interior, dated January 29, 1952, stated:

> "Frequently, the proved reserves are compared with the current annual production to arrive at the number of years that supplies will last. By such calculation it would have seemed almost any time in the past that supplies could last only ten to twenty years. On this basis there have been many predictions that we are running out of oil. Such predictions are nonsense today, because they fail to consider the rate of oil finding and development. It is future supplies, not presently known reserves, that will determine available supplies for the long run." (102: 13,453, line 22—13,454, line 7)

This statement, of course, is equally applicable to natural gas finding and development.

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Dr. Kahn testified that the seemingly sharp drop in the life index since 1946 was actually not as significant as suggested; that the 1946 life index of 32.5 years represented a historical peak, resulting from accumulating reserves of dry gas in the period before World War II and continued discoveries incident to the search for oil—all in the face of an only gently increasing demand for gas. This abnormal upward thrust was thereafter reversed as the result of a sudden acceleration in the expansion of demand due to the development of long-distance pipelines and interstate markets in the post-war period, giving rise to an enormous increase in total production. In the immediate post-war period 1946-1951, marketed production increased by an average of 13.1 percent annually, representing the highest rate of increase in the past thirty years. Dr. Kahn pointed out

that it is now generally agreed in the industry that the *growth rate* of demand for the past ten years will not be maintained.[179] The Chase Manhattan Bank contemplates an average increase in the production of natural gas during the next decade of only 4.7 percent per year, and this was approximately the growth rate assumed by Phillips witness Turner in his Exh. 293. The President's Materials Policy Commission [180] forecasts an average annual growth rate of 3.6 percent for the production of gas through 1975. It will be observed that these estimated rates of growth for the next decade are considerably lower than the average experienced in any of the five-year periods since 1926, or in any of the six-year periods since 1932. (pp. A1 and A3 of the Appendix to Phillips' initial brief) Thus although it is not denied by Dr. Kahn that there will be a continued increase in the *absolute level* of demand for natural gas, the *rate of growth* of demand is tapering off, and he concluded that this forecasts a similar tapering off in the decline of the life index. (102:13,446-49)

Turner estimated that the demand for natural gas would increase from the actual demand of 10 trillion cubic feet per year in 1955 to 15 trillion cubic feet per year in 1965. (Exh. 251, Panel B; 8915-16)[181] Based upon the estimated increasing demand, he concluded that in order to maintain our present 22-year life index, annual average additions to reserves should amount to 23.6 trillion cubic feet per year for the next nine-year period, as compared with an annual average of 16 trillion cubic feet found during the preceding nine-year period. (115: 15,367)

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[179] Phillips itself states, at p. 10 of its initial brief: "We agree with Kahn that the percentage rates of increase in demand will not be maintained."

[180] Referred to as the Paley Commission.

[181] Dr. Kahn accepted these figures. (Exh. 390, Sched. 4; 115: 15,365)

It should be noted here that all of Turner's conclusions with respect to the national gas supply picture are based upon his unsupported assumption that maintenance of the current 22-year life index is an essential objective. Dr. Kahn, on the other hand, based his studies upon the objective of maintaining a 20-year life index, explaining that this was based upon such factors as: (1) the common practice of underwriters to require that a pipeline company have twenty years' supply under contract before they will underwrite pipeline debt; (2) the practice of the Federal Power Commission, with respect to new major pipelines, to require an estimated life index of twenty years. (102: 13,451)[182] Since a life index of twenty years has been regarded by the Commission as an adequate criterion in evaluating the adequacy of gas supply in pipeline certificate cases, it is difficult to see why our instant evaluation of the national gas supply picture should be based upon the use of a 22-year life index as an essential measuring stick.

In Exh. 390, (Sched. 4, Col. 4) Dr. Kahn set forth his calculations as to the annual additions to reserves which would be required from 1957 to 1965 in order to maintain a 20-year life index, assuming Turner's estimated demands for each of those years. These estimated requirements, for this period, amounted to a required annual average addition of 22.8 trillion cubic feet. Although the average annual additions actually experienced for the period 1948-1956 amounted to 16.2 trillion cubic feet, the annual average of new supplies went up from 14 trillion cubic feet for the period 1946-1949, to over 19 trillion cubic feet for the period 1953-1956.[183] It further appears that in 1956 and 1957 alone,

[182] Dr. Kahn further noted, in this connection, that with respect to established pipeline companies even this standard had been considerably relaxed by the Commission since 1948.

[183] As will be noted shortly, the average for this latter period was distorted in a downward direction by the inclusion of the abnormally low year of 1954.

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23.5 trillion cubic feet per year were added on the average, culminating in an actual addition to reserves amounting to 24.8 trillion cubic feet for the year 1956 (Exh. 390, Sched. 1; 118: 15,889-90) Dr. Kahn estimated that, based upon Turner's estimated demands for the future, this last figure would not have to be exceeded until 1965, when a new supply amounting to 27 trillion cubic feet would be required. In view of the recent trend, as outlined above, Dr. Kahn did not regard the 22.8 trillion cubic feet annual average, required for the ensuing years in order to maintain a 20-year life index, as constituting a serious problem.

Dr. Kahn's Sched. 4 (Exh. 390) similarly indicated that, based upon Turner's estimated demands for the years 1957-1965, in order to maintain a 20-year life index the finding rate (or growth factor) for those years would have to amount to an annual average of 1.75. (Sched. 4, Col. 5)[184]

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Turning to the question as to whether it could reasonably be anticipated that these goals would be achieved in the years to come, Phillips witness Turner took a pessimistic view of the situation, based upon the finding rates actually experienced during the preceding decade, which he characterized as indicating a declining growth factor trend. He stated:

> "In spite of the continued growth of proved gas reserves, the enormous gas demands caused the gas reserves-production ratio to decline without interruption from 32.5 to 22.1, and the growth factor to decrease from 2.12 average for 1947 and '48, to 1.62 average for 1954 and 1955." (57: 8062)

Dr. Kahn, however, contended that this created a totally erroneous and misleading impression. He pointed out that

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[184] The finding rate, or growth factor, represents the ratio of annual reserves added, to annual production.

both he and Turner had used the same figures, but that the apparent decline in the growth factor as presented by Turner resulted exclusively from the fact that Turner had included in his 1954-55 terminal average the year 1954, which showed an abnormally and unrepresentatively low finding rate of 1.02. (Exh. 390, Sched. 1) Dr. Kahn explained that this unusually low finding rate for 1954 resulted from the fact that in that year [185] there was a sharp downward revision of the prior natural gas reserve estimates made in many states, combined with lower than usual upward revisions in other states; that this produced an unprecedentedly low nation-wide figure for "extensions and revisions", which constitute a large percentage of "new supply". (Exh. 390, Sched. 1, Cols. 1, 2 and 3) As a result, the extensions and revisions for 1954 were only 61 percent as high as those for the next lowest year in the post-war period. (*i.e.*, 1947). They were only one-third to one-fifth as high as the extensions and revisions for the years 1953, 1955 and 1956. (102: 13,443; 115: 15,319) He explained that the 1954 extensions and revisions were "of an extraordinary character"; that in order to test this conclusion, he had made a detailed step-by-step breakdown of these figures for 1954, obtaining the following results:

(1) Negative extensions and revisions (i.e., downward estimates) amounted to 7.76 percent of positive extensions and revisions in 1947; 1948—2.25 percent; 1949—1.60 percent; 1950—1.65 percent; 1951—0; 1952—0; 1953—1.31 percent.

(2) However, in 1954 negative extensions and revisions shot up to 20.24 percent.

(3) Thereafter, the ratios dropped down again to 0.02 percent in 1955 and 0.15 percent in 1956.

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[185] The year of the Supreme Court's *Phillips* decision, *supra*.

It is concluded that the data set forth above demonstrates beyond contradiction that 1954 was an atypical and completely unrepresentative year.

Dr. Kahn then noted that the eleven-year post-war period from 1946-1956 showed an average growth factor of 2.09. He concluded that this period included two atypical years—(1) the year 1954, which was atypically low; (2) the year 1946, which was atypically high, with a growth factor of 3.59. He accordingly eliminated both of these atypical years from the average of the post-war period, obtaining an adjusted average growth factor ratio of 2.04 for that period. (102: 13,442-43) He then further noted that aside from the atypical year 1954, the growth factor had fallen below 1.66 in only one post-war year, and that the ratio was 2.28 in 1956, the most recent year on record. This was the highest growth factor ratio experienced since 1948, reflecting the greatest increase in reserves in our post-war history. Based upon the above studies, Dr. Kahn concluded that the average annual growth factor rate experienced during the past decade (adjusted as indicated above) was 2.04; that on the basis of his estimate that an annual average finding rate of 1.75 would be required in order to maintain a 20-year life index for the nine-year period 1957-65 (assuming Turner's estimated demands for this period), the desired 20-year life index could be successfully maintained with finding rates, or growth factors, lower than those already experienced in recent years.

Phillips witness Turner, however, stresses the fact that in order to arrive at any realistic conclusions with respect to the gas supply situation, it is necessary to direct our attention not only to such matters as the national life index, but also to deliverability problems. It is recognized that, due to inherent deliverability problems, the life index, of course, does not constitute a measure of the reserves that

can actually be *delivered* within the stated number of years. (118: 15,913) This problem arises because of the fact that when production from a given well or reservoir reaches a certain point, the well or reservoir will thereafter produce only at a declining rate until it is completely exhausted—although it also means that production will stretch out for a longer number of years than the life index period. Turner used the term "breaking point" as the point at which the gas from a given reserve, due to deliverability problems, can no longer be produced at the given rate. He used the term "breaking point interim" to describe the period of years remaining before such breaking point would be reached, assuming that no new reserves were discovered and that production were to continue at the current rate. He then concluded that, based upon our current total national reserves and the current annual rate of production, our present national life index of 22 years is sufficient to maintain a 14-year breaking point interim, and that it is essential that such a 14-year breaking point interim should always be maintained.

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The only rationale submitted by Turner in support of this position was his statement that:

> "In my opinion so long as we continue to make investments in pipeline and distributing facilities we will be in an unhealthy position whenever we let that interim become less than it is now." (70: 9669-70)

Actually, it is clear that Turner's selection of a 14-year breaking point interim as an essential requirement was based upon his assumption that maintenance of the current 22-year life index is an essential objective. However, as already noted, it has here been concluded that no persuasive reason has been shown as to why the conventional 20-year life index should not be used as the yardstick.

Turner's next contention was that although our current 22-year life index is sufficient *at this time* to maintain the current production rate for 14 years, he does not expect this situation to continue in the future. His theory here was that the maintenance of the 14-year breaking point interim along with the 22-year life index "depends upon the national deliverability maintaining its present relationship to reserves"; that so long as this relationship is maintained, the breaking point interim will be extended proportionately as the reserves-production ratio is extended. (65: 8918, lines 12-17)

However, he concluded that, because of four different factors listed by him, the national deliverability in fact will not maintain as high a ratio or relationship to reserves as it now reflects. (65:8918, lines 17-19) Because of these pessimistic assumptions, Turner finally concluded that in order to maintain our present 14-year breaking point interim, it would be necessary to maintain a 1.5 growth factor even if demand were to remain constant at its present level; but that, based upon his estimated increasing demands, an even higher growth factor of 1.9 would be required. He stated in this connection:

> "In brief, if the estimated increasing demands are to be supplied, enormous discovery rates must be reached and maintained and the average annual discovery rate must be about 1.9 times the average annual withdrawal rate." (65: 8918, lines 3-6; 8924, lines 19-22)

As just noted above, these final pessimistic Turner conclusions are based upon his assumption that the national deliverability will not maintain its current relationship to reserves. This assumption was based, in turn, upon the following four factors, set forth by him in some detail:

(1) He concluded that

> " a very large portion of our present production is from reservoirs which have declined to a point of very low deliverability. In other words, we have become a nation of partially depleted reservoirs." (65: 8921, lines 5-8)

While listing this as a significant problem, Turner ignored the fact that by far the greater proportion of our future supplies of natural gas will come not from presently estimated proved reserves, but from supplies yet to be found and proved in the future. (118: 15,914-15) Since our future requirements will therefore be met in increasing degree from newly discovered reservoirs whose deliverability will be relatively high, the problem here raised by Turner does not appear to be significant.

(2) The next factor listed by Turner is that a large volume of the reserves now estimated to be recoverable will not be available

> "due to uses in the field for which no account is taken either in the estimate of recoverable reserves or in the estimate of markets. This is the gas used as fuel in pressure maintenance, gas cycling, and other reinjection operations." (65: 8921, line 17)

(3) The third factor is based upon his contention "that we are finding smaller and smaller fields". (65: 8923, line 8)

(4) His fourth factor is based upon the contention that

> "As we have drilled deeper and deeper and particularly as we have begun to develop off-shore, in deep and extremely high pressure reservoirs, the industry has continued to have occurrences of blow-outs and losses of

wells, equipment and gas. So far there is no indication that we can ever come close to eliminating all of these losses." (65: 8924, line 6)

It is important to note here that all of the four factors referred to by Turner, as outlined above, are highly speculative in nature. Although they raise problems which *may* be encountered, he completely failed to recognize or suggest any of the natural counterbalancing factors which may just as reasonably be speculated upon as possible ultimate solutions to minimize the effects of such problems. A good example of this flaw in the Turner presentation will be bound with reference to his fourth factor, *supra*, where, referring to the problem of blow-outs encountered in connection with off-shore drilling, he stated:

"So far there is no indication that we can ever come close to eliminating all of these losses."

This statement, of course, ignores the basic fact that off-shore drilling represents a relatively recent development in the petroleum industry. The history of this industry has indicated a high level of ability to meet its developing problems, both those of a technological nature and in other areas. It would seem totally unrealistic, and indicative of an unwarranted lack of confidence in the industry, to fail to recognize that as greater experience is had in the problems of off-shore drilling, new technological advances will undoubtedly contribute to a minimizing of such problems.

In connection with his discussion of the four factors listed above, Turner stated:

". . . we have no way of knowing that the discovery in any year of a volume of reserves equal to the volume produced during that year will maintain the national deliverability. I know of no way to calculate the effect

but, in my judgment, in the present status of withdrawals in the nation, something more than one for one discovery rate or growth factor is required for this cause alone." (65: 8921, lines 10-16)

It is interesting to observe that, after thus conceding that he knew of no way to calculate the effect of these problems, Turner proceeded to lay down as a precise rule that, due to these very factors, it is essential to maintain a 1.9 growth factor, or finding rate, on the basis of his estimated increasing demands.

It is concluded that the type of speculation thus indulged in by Turner does not provide a satisfactory basis for drawing any meaningful and fair conclusions as to the problem here under consideration. However, if any weight whatsoever were to be given to the Turner speculations, pitched in a pessimistic direction, it would become necessary to indulge in equally meaningful speculations pitched in the opposite direction, in order to provide a more balanced perspective with respect to the entire question of our national gas supply. In this connection, it would seem equally justifiable to take into consideration the following matters:

(1) *The Possibilities Inherent in Off-shore Drilling.* Eastern contends that the results of off-shore drilling to date suggest "a particularly bright outlook for future reserves". (initial brief, pp. 9-10) It appears that, although it has been estimated that the average off-shore well, including dry holes, has cost eight or nine times as much as the average on-shore well, it has, on the other hand, found eight to nine times as many reserves. (102: 13,462, 13,464) It appears that off-shore drilling expenditures made up to the end of 1956 had already proved out an estimated four trillion cubic feet of gas, and it had been estimated that it was entirely possible that discoveries made up to the end of 1957 would ultimately provide an off-shore reserve amounting to 14 trillion cubic feet of natural gas. (118: 15,885)

During cross-examination of Dr. Kahn on this subject, Phillips counsel directed attention to the high finding costs of off-shore discoveries, amounting to $14 per barrel of crude oil. Dr. Kahn, however, criticized this figure as "an accounting monstrosity". (118: 15,884, lines 20-21) He explained that this figure was obtained by dividing the aggregate capital expenditures off-shore by aggregate production to date; that the resulting figure was naturally unrepresentatively high, because it reflected high initial cost of investments thus far made which, although they had established production *capacity*, had not as yet borne fruit in correspondingly large current production. He suggested that if current estimates of the possible ultimate recovery of upwards of 1.75 billion barrels of liquids should prove sound, the finding costs might ultimately turn out to be less than $1.00 per barrel (even if it were assumed that the *gas* discovered had no value whatsoever).[186]

It is recognized that the data presented in the instant record with respect to the current results and estimated potential of off-shore drilling is too meager to provide the basis for anything more than speculative conclusions. However, it is sufficient to indicate that the potential of off-shore drilling cannot realistically be ignored as a significant source for future gas supplies. It is noted, in this connection, that Phillips itself is heavily engaged in off-shore exploration; that it "has been operating extensively off-shore", and has "large uncommitted reserves" in the off-shore area. (93: 12,500, 12,502, 12,546-47)[187]

(2) *The Possibility of Future Imports from Canadian and Mexican Natural Gas Reserves.* Dr. Kahn referred to

[186] 118: 15,885.

[187] In spite of this, Phillips itself makes no reference whatsoever to the subject of off-shore drilling in either of its briefs filed in the instant proceeding.

the possibility that imported gas from geographically adjacent countries (i.e., Canada and Mexico) might become increasingly available in future years to meet projected needs. (102: 13,451; 115: 15,454-56) Such possibilities, of course, are completely in the realm of speculation at this time. With respect to Canadian reserves it is indicated that, at this initial stage of development, the volumes of natural gas available for export may be limited. However, it would be totally unrealistic to overlook the Canadian reserves as a possible source at some future period.

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The pessimistic assumptions presented by Phillips witness Turner may also be balanced by a consideration of certain other statistics of a more encouraging nature. For example, the number of exploratory wells drilled annually by the industry has almost tripled over the past decade. (Exh. 390, Sched. 8) In addition, the total footage of oil and gas wells drilled (including new field wildcats, exploratory, and development drilling) had increased by 152 percent in the period 1945-1956; and even more significantly, with respect to strictly exploratory drilling there was an increase of 221 percent in footage drilled during the same period. (Exh. 390, Sched. 5; 102: 13,455) Finally, it is important to note in this connection that, notwithstanding this rapid increase in exploratory activity, the success ratio for exploratory wells drilled has remained roughly constant during the period from 1946-1956; that, in fact, successful exploratory wells have constituted a noticeably higher percentage of all exploratory wells drilled during that period than in the immediate pre-war years. (Exh. 390, Sched. 8, Col. 3) In this connection Dr. Kahn, referring to the rise in the percentage of dry holes encountered in recent decades which has been stressed in some quarters, pointed out that this change has nevertheless been accompanied by a constant success ratio within the exploratory wells category.

He explained that since dry holes understandably occur with greater frequency in the case of *exploratory* wells than in connection with developmental wells, and since *exploratory* wells have been constituting an increasing proportion of all wells drilled, it is quite understandable that an increasing percentage of dry holes would be encountered during this period; but that this is no cause for alarm in view of the constant success ratio maintained within the exploratory wells category. (102: 13,456-57)

Entirely apart from everything said above with respect to the national gas supply picture, it is of interest to note, in this connection, the following material facts with respect to Phillips' own gas supply picture:

(1) Phillips itself has a 30-year life index, far above the national level. (88: 11,896; 102: 13,454; Exh. 286)

(2) Phillips witness Tarner testified that Phillips "has built up. . . . a tremendous reserve of gas". (65: 9011-12; 66: 9171-72)

(3) The Phillips policy witness, Stanley Learned, testified:

> "As we spend more money for exploration I feel sure we are going to get large reserves of both oil and gas . . .". (93: 12,530)
>
> • • • • •
>
> "We have had pretty good results the first quarter of 1957. You can't take this finding of reserves of oil and gas on any short-term basis, because it is kind of like a card game. You have a series

> of luck, with all the science you put in it, you still have to do a bit of it by luck." (93: 12,531)

(4) In addition, it is relevant to note, in this connection, the following statement made on the record by Phillips' counsel:

> ". . . . I wish you would go back and read my opening statement and the statements in the testimony of Mr. Tarner and Mr. Turner in which we all flatly stated that we were not predicting doom for the gas industry or a shortage of gas." (102:13,487, lines 18-22)

In addition to the matters outlined above, Phillips suggests (initial brief pp. 19-22) that the requirements of consumers, distributors and pipeline companies for supplies of natural gas can presently be met only out of production from wells, to any significant degree, and from no other source; that motorists and other users of oil products, on the contrary, have many potential sources of supply, such as the possibilities for development of reserves of shale, and imports of crude oil. The Phillips presentation on this point is undoubtedly designed to rebut the argument that, because of their general petroleum product requirements, producers will in any event continue to search for oil; that in the course of this search for oil new gas reserves will continue to be discovered, regardless of the prices fixed for natural gas. If there is any suggestion here that such possible alternative sources for crude oil may ultimately result in exploration for and production of crude oil from wells being significantly cut down or abandoned, with a resultant loss of such operations as a source of supply for natural gas, any such implication is here rejected as being completely speculative and remote. The fact is that the economic, engineering and other factors which would be required to produce such a situation certainly are not present at this time, and the possibility is too remote to be given any weight whatsoever in our present determinations.

(31592)

With respect to the suggestion made by Phillips witnesses that a gradually increasing percentage of total domestic oil requirements have been met by oil imports since 1948, Dr. Kahn pointed to the consistent policy of the United States government to hold imports within reasonable bounds. He noted that a Cabinet Committee in 1955 recommended that imports of crude oil be held to their 1954 relationship to domestic production, being a ratio of 10.34 percent, and that a roughly similar ratio was again recommended in 1957. He also pointed out that under the Cabinet Committee formula of 1957, Phillips itself was required to hold its oil imports down to 12,000 barrels per day; that, by way of comparison, its average net crude oil production in 1956 was approximately 150,000 barrels per day; and its average refinery through-put of crude oil was almost 245,000 barrels per day. Under these conditions, it seems reasonable to assume that the import possibilities and their impact on Phillips' domestic exploratory activities will be relatively minor. (102: 13,468-71)

31593

B. *Increasing Depth of Drilling, Accompanied by Increasing Costs.*

Phillips contends that it is faced with the necessity of drilling to constantly increasing depths in order to find and develop new reserves. In this connection, it is contended that since Colonel Drake's well was drilled in 1859 to a depth of 69½ feet, drilling has gone deeper and deeper until the industry is now drilling wells more than 20,000 feet deep, or four miles down; that the annual number of wells

[187a] In this connection, it is relevant to take official notice of the fact that by Presidential Proclamation No. 3279, issued on March 10, 1959, mandatory restrictions were imposed on the importation of petroleum and petroleum products into the United States.

drilled below 12,000 feet had risen to 1,200 wells in 1956, compared with 145 such wells in 1948; that the number drilled below 15,000 feet had risen to 142 wells by 1956.

It is noted, however, that the really significant data to be considered in connection with this problem is the *average* well depth, and here we see a rather different picture. Dr. Kahn's Exh. 390B indicates that the average well depth of "all new wells" was 4,041 feet in 1956, and that the average depth for "all exploratory wells" was 4,574 feet. The average depth for all exploratory wells drilled from 1938-1955 increased only 1,272 feet. Phillips argues that the average well depth figures relating to "all new wells" in Exh. 390B, Col. 1, obscure the fact that numerous shadow wells are drilled each year in "old stripper oil areas", and in secondary recovery operations, which reduce the national average depth but which furnish no gas for the consumer. However, this argument becomes unimpressive when it is noted that the "all exploratory wells" category, set forth in Col. 2, which does *not* include the shallow wells drilled in old stripper oil areas, presents a picture quite similar to the Col. 1 data.

Entirely apart from the above, it is important to bear in mind here that whatever high level of costs had actually been reached in the test year 1954, reflecting the depth of drilling then encountered by Phillips itself, is actually accounted for in our instant 1954 test year cost of service. In addition, the 1956 cost-of-service study introduced by Phillips (Exh. 303), already referred to at an earlier point in this decision, reflects the more recent 1956 exploration and production costs, including any further cost increases which may have taken place by that time as a result of any continuing trend toward deeper and deeper drilling. It is significant that, despite the instant Phillips contention, the total deficiency shown on Exh. 303 for the 1956 cost-of-service study is not substantially higher than that shown on Phillips' 1954 test year cost of service. (Exh. 282)

The only other possible significance of the depth-of-drilling data presented by Phillips would be to support a contention that its exploration and production costs are in a continually rising trend; that accordingly both the 1954 test year costs and the 1956 cost-of-service study are already out of date, and no longer reflect what Phillips needs in order to provide an incentive for continued exploration.

However, this suggestion is not persuasive in view of the Exh. 390B data indicating that the increase in average depth for "all new wells" since 1938 has amounted to only 54 feet per year, whereas the increase in average depth of "all exploratory wells" from 1938 to 1956 has been only 63.8 feet per year. These figures would not seem to indicate a very sharply rising trend for the increase in average depth of wells drilled. Of course, if it should develop in some future year, as a result of this trend and any other cost changes, that the 1954 test year relationship of operating costs, plant and volume of sales was no longer representative, any necessary and appropriate rate adjustments could then be made as the result of a new rate proceeding.

Phillips further stresses, in this same connection, that 31 percent of the nation's marketed natural gas production is now being produced from gas condensate wells and that the average depth of such wells drilled nationally in 1956 was 9,300 feet; that 26 percent of the marketed natural gas production currently consists of casinghead gas obtained from oil wells, and that the average depth of such wells is 6,200 feet. (Phillips initial brief, pp. 31-32) However, this data may be viewed in better perspective when it is recognized that the *average* depth for "all exploratory wells" in 1956 had risen only to 4,574 feet (Exh. 390B), in spite of the fact that this figure includes and reflects all of the exploratory *condensate well* producers and all of the exploratory *oil well* producers which were drilled in that year,

thus giving full weight to the more significant role played by the gas condensate wells and oil wells by that time.

No question is raised here as to Phillips' basic premise that, all other factors remaining equal, deeper drilling is more costly than shallow drilling—nor is it denied that inflation has had an effect upon drilling costs. However, it is relevant to note here that Phillips did not present any figures showing total over-all increases in its own drilling costs due to deeper drilling, or even total over-all nationwide increases. Instead, it merely presented Exh. 233 to demonstrate that

> "The cost of drilling one additional foot at a depth of 10,000 or 15,000 feet is many times the cost of drilling one additional foot at 1,000 feet." (initial brief, p. 25)

The significance of this observation becomes much less serious when it is recognized, as already noted above, that although a much larger number of wells are currently drilled at deeper depths than in earlier years, nevertheless the average depth of "all exploratory wells" drilled in 1956 had still not risen above 4,574 feet.

In addition, it is conceded that *decreases* in cost due to technological progress have provided a partially offsetting factor. Thus, Dr. Kahn noted that the average total cost per foot of oil wells drilled in 1956 amounted to $13.75 per foot, as compared with a 1950 cost of $11.00 per foot. (Exh. 390, Sched. 13, Col. 5) However, he testified

that if these costs were adjusted for changes in the value of the dollar, retaining only that portion of the cost increase attributable to the increased cost of deeper drilling, it would be found that the real cost of drilling wells had declined, not risen, during this time period. He concluded that this was the result of "striking technological progress" of recent years. (102: 13,460-61)

In addition, although increased drilling costs are not to be ignored, it is also significant to measure drilling costs in relation to the *value* of oil and gas reserves discovered. Here we find that since the end of World War II, although drilling costs per dollar of oil alone discovered rose from 26 cents to 38 cents during the period 1946-1956, drilling costs per dollar of *both oil and gas* discovered rose only from 22 cents to 27 cents in the same period. (Exh. 390, Scheds. 13 and 15)

C. *Increasing Exploratory Costs.*

At pp. 32-34 of its initial brief, Phillips sets forth certain data under the heading of "increasing exploratory costs", comparing its total leasehold costs for 1946 with those for 1955, and making similar comparisons for total geophysical expenditures, Land and Geological Department operating expenses, and dry hole expenses and contributions. However, these figures are only meaningful if considered in connection with the accompanying increases in the volume of reserves added. Total natural gas reserves added rose from 17.7 trillion cubic feet in 1946 to 22 trillion cubic feet in 1955. (Exh. 390, Sched. 1) It is thus apparent that the total increase in over-all exploration costs was not entirely due to the increasing costs of exploration *per se*, but reflects in part the expansion of Phillips' exploration activity during these years, which, of course, resulted in higher reserves, higher production and higher revenues.

D. *Decreasing Discoveries Per Unit of Drilling.*

Phillips presented data indicating that during the past ten years the reserves added per exploratory well drilled have decreased 39 percent for gas and 43 percent for oil; and that the reserves added per million feet of exploratory hole drilled have decreased 48 percent for gas and 51 percent for oil. (initial brief, pp. 35-36) It is pointed out that

in the earlier years relatively large reservoirs were found, at relatively shallow depths; that most of the shallow formations where oil and gas might occur have now already been explored; that accordingly deeper and deeper wells are being drilled, finding reservoirs which are relatively smaller and which contain lesser reserves per total reservoir. (57: 7934; 70: 9680) However although it is true, as indicated by Phillips witnesses, that deeper drilling is currently required if reserves are to keep pace with demand, the fact is that such deeper drilling *has* been taking place and that reserves in fact have kept pace with demand. As set forth in detail at an earlier point, increasingly

greater amounts of new gas reserves have been discovered in recent years, culminating in 1956 with a peak of 24.8 trillion cubic feet. (Exh. 390, Sched. 1) As already noted, the record here presented provides no basis for doubting that the industry will be able to achieve the necessary rate of discovery required in the years to come to meet the expanding needs of the market. It is true, of course, that the deeper drilling required for this purpose will be more costly. However, it is worth repeating again that the 1956 cost-of-service study here presented by Phillips demonstrates that whatever higher levels of drilling cost had been reached by that year were apparently counterbalanced by other factors—since the 1956 cost-of-service study showed an over-all deficiency not strikingly higher than that shown in Phillips' test year cost of service.

E. *Increasing Investment and Declining Earnings.*

Phillips presented Exh. 237 to demonstrate that its net investment per million Btu of both gas and oil sold increased from 25.5 cents in 1946 to 56.9 cents in 1956; and Exh. 261 to demonstrate that its earnings (before taxes) on net investment in its total oil and gas production, gas

gathering and gas processing facilities declined from 29.5 percent in 1948 to 8.3 percent in 1956.

The important thing to bear in mind with respect to the data set forth in Exhs. 237 and 261 is that it represents combined oil and gas data. If such combined oil and gas statistics were used as the justification for allocating to natural gas a higher proportion of total exploration costs than justified by the role it plays in the relative results achieved from joint exploration activity, the result would be to impose upon natural gas alone the burden of carrying the entire oil and gas data trend referred to above. It is concluded that the amount of *jurisdictional* revenue which Phillips reasonably requires is governed by the cost-of-service here determined upon the basis of the detailed considerations already set forth in this decision; and that data indicating that Phillips' ratio of net earnings to net investment for its *combined oil and gas production* has declined from a higher figure in 1948 to a lower figure in 1956, does not of itself provide the basis for any cost of service determination in this proceeding.

F. *The Phillips Contention That Increasing Gas-Oil Ratios are Encountered With Increasing Depth.*

A great deal of time was devoted during the hearing to evidence presented by Phillips in support of its thesis that increasing gas-oil ratios are encountered with increasing depths, and to rebuttal evidence presented by interveners Pacific and Eastern for the purpose of controverting this theory. The Phillips theory is: (1) that deeper reservoirs contain a higher percentage of gas and a lower percentage of oil than shallower reservoirs—*i.e.*, a higher initial gas-liquid ratio;

(2) that the deeper reservoirs, with such higher initial gas-liquid ratios, will produce less of the oil in place than reser-

voirs with lower gas-liquid ratios—*i.e.*, the deeper reservoirs have lower oil recovery factors. (Phillips initial brief, pp. 26-30)

The Phillips presentation on this subject was designed to establish that gas is no longer a "junior partner"; that it therefore can no longer properly be contended that the producers' motivation is really to search for oil, that any discoveries of gas are only incidental to that search, and that accordingly oil should bear the major part of the burden of exploration costs. This presentation is also designed to indicate that Phillips is increasingly dependent upon its income from natural gas; that accordingly it is neither practical nor fair to expect oil to carry the burden of increasing costs. The Phillips thesis in this connection is succinctly stated as follows:

> "gas, which has heretofore had a free ride on the search for oil, must now bear its fair share of the cost of the search." (Phillips reply brief, p. 27)

It will be observed, however, that this entire argument constitutes a meaningless "straw man", unless made in the context of an assumption that the methods here adopted for the allocation of exploration costs between oil and gas are in fact motivated by an objective to load upon oil those costs which properly and fairly should be borne by gas. It is concluded that no such assumption is valid, since there is here allocated to gas all that portion of total exploration costs properly assignable to that product, based upon the application of the RAR method—which fully reflects the increasingly important role of gas, relative to oil. As already noted in detail at an earlier point in this decision, the inherent nature of the RAR allocation method is such that it fully reflects and gives full weight to any changes which may occur in the relative volumes of both gas and oil reserves added through exploration, whether as the result of changes in the gas-oil ratios or through any other causes. If this

relationship, as reflected in the test year data, should later become unrepresentative, Phillips would have the opportunity in a future rate proceeding to present evidence indicating a change in the relative volumes of oil and gas reserves added, and a new RAR ratio would then be arrived at, resulting in the allocation of a different percentage of exploratory costs to gas. (102: 13,467) In addition, it should be noted that under the RAR method natural gas reserves are valued at the 1956 *new* contracts price of 13.47 cents per Mcf—a valuation which does not reflect, and is not tainted with the impact of the old, long-term, low-priced contracts, executed at a time when gas truly was still a "junior partner".

Another possible implication to be drawn from the Phillips contention with respect to increasing gas-oil ratios is that it is designed to indicate that an increasingly greater proportion of total hydrocarbons discovered consists of natural gas; that accordingly there is

no longer any justification for the argument that much the bigger share of the producer's total hydrocarbon income comes from oil, and that the price of oil is accordingly a more important factor than the price of gas in influencing the determination by major producers as to where and how much to drill.

If we accepted, for the purpose of this discussion, the Phillips theory that higher gas-oil ratios are encountered with increasing depth, this would merely indicate that in the case of *associated gas wells*,[188] as we drill deeper, gas produced by such wells will represent a greater *percentage* of the total hydrocarbon recovery than it does in the shallower associated gas wells. However, the really significant fact to bear in mind here is that it will nevertheless still be

[188] Gas condensate wells and oil wells producing casinghead gas.

true that the total oil revenue from such associated gas wells will represent the major part of the total hydrocarbon revenue from such wells. The record indicates that Phillips' oil revenue from joint product leases for the year 1954 was $87,245,481, whereas its natural gas revenue from joint product leases was only $13,515,089. (Exh. 353, p. 4, Col. 2; Exh. 304, line 2) It thus appears that in 1954 oil accounted for 86.58 percent of the total hydrocarbon revenue from Phillips' associated gas wells, while gas accounted for only 13.42 percent of the combined revenue. It accordingly seems clear that regardless of the validity of the Phillips theory with respect to increasing gas-oil ratios, the price of oil will still be of greater interest than the price of gas in connection with associated gas wells. Furthermore, Phillips itself has stressed the fact that more and more of our marketed natural gas production is coming from associated gas wells, rather than from dry gas wells—*i.e.*, 57 percent from associated gas wells, and only 43 percent from dry gas wells in 1955. (Phillips initial brief, p. 31) Under these circumstances it would seem clear, as contended by Dr. Kahn,[189] that the price of oil will remain a more important factor than the price of gas in influencing the determination by major producers as to where and how much to drill.

For the reasons set forth above, it is concluded that no purpose would be served by attempting to resolve here the seriously contested issue as to whether increasing gas-oil ratios are in fact encountered with increasing depth. As noted above, the interveners and the Staff hotly disputed this Phillips theory. Eastern disputes the broad Phillips premise that higher initial gas-liquid ratios are encountered in deeper reservoirs, contending that the evidence presented by Phillips on this point is applicable only to saturated reservoirs. Both Eastern and Pacific dispute the Phillips

[189] 102; 13,484; Eastern initial brief, p. 16.

position that deeper reservoirs have lower oil recovery factors.

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They contend that the position taken by Phillips witness Tarner on this subject is unsound because it considered only the effect of shrinkage; that there are other factors which must be considered and which have a greater influence upon the recovery factor than shrinkage, the principal one being the mobility of the oil; that lower viscosity increases the mobility of the oil; that viscosity decreases with depth; that accordingly the increased mobility of the oil in deeper reservoirs more than offsets the effect of shrinkage. (Phillips initial brief, Appendix A4—A11; Exh. 371; Pacific reply brief, p. 204; Staff initial brief, pp. 51-54) This issue has resolved itself into a battle of experts which consumed much time in the open hearing and in the briefs filed by the parties herein. It involves a highly technical question, which it is difficult to resolve with any satisfaction on the instant record. Since it has already been concluded, as set forth in detail above, that the answer to this technical and disputed question would not only any event justify any change in the cost-of-service determinations reached in this decision, the matter does not merit further discussion.

G. *General Conclusions With Respect To The Phillips Presentation On Problems Of Demand, Supply And Increasing Costs.*

It will be helpful at this point to back away from the precise, detailed analysis of the Phillips data presented on these related subjects, and to consider in more general terms the appropriate place and significance of such data in connection with the problem of determining just and reasonable rates in the instant proceeding. Our objective in developing the instant cost-of-service is to allow and reflect Phillips' total jurisdictional costs of all kinds at the

level which they had reached during the 1954 test year, as adjusted for appropriate "known changes". The year 1954 has here been adopted as the test year on the theory that the ratio between Phillips' operating expenses, plant and volume of sales during that year, as so adjusted, was in fact fairly representative of the ratio which will pertain for the ensuing years. However, if it is to be contended that the Phillips level of drilling and exploration costs has so risen since that time that the level of such new costs, considered in connection with the more recent levels of other operating costs and the more recent levels of plant and volume of sales, have established a new plateau, and that the 1954 test year is accordingly no longer representative, then the logic of the situation would require the adoption of a more recent test year in this proceeding.

On the contrary, however, no contention is here made by Phillips that the case should be presented on the basis of a different and more recent test year. Instead, we find that the data presented by Phillips with respect to increasing drilling costs does not in any way purport to represent a comprehensive study of precise total increased costs incurred by Phillips itself, but rather that it takes merely the form of nationwide trend statistics for the entire petroleum industry. Furthermore, with respect to Phillips' own costs we find that the more recent 1956

cost-of-service study presented by Phillips itself shows an over-all deficiency which was not significantly higher than that derived in Phillips' 1954 test year cost of service.

Under these circumstances, although the various types of nationwide trend statistics presented by Phillips on these subjects are of general interest, as indicating changes which have been and are taking place in the petroleum industry, this data does not justify or require a change in any of the

basic cost-of-service determinations made herein with respect to the Phillips cost of service.

On this entire subject, Phillips has here painted a dark and pessimistic picture, implying that the gas supply situation is critical; that accordingly we must develop extraordinary new incentives by shifting the bulk of the exploratory burden to the natural gas consumers; that unless this is done, it will not be possible to achieve the "enormous" rates of increase in the discovery of additional natural gas reserves which allegedly will be required to meet future demands. On the other hand, some of the other parties to the instant proceeding suggest that there is really no great problem at all. It is concluded that the more accurate and objective conclusion to be drawn from this entire presentation is that it is of the utmost importance that there be continued exploration for and discoveries of additional gas supplies on the levels required by our increasing demands. This was recognized by Dr. Kahn when he stated:

> "The ratio of reserves to current production certainly bears watching." (102: 13,445, lines 22-23)
>
> • • • • •
>
> "At no point in my testimony did I attempt, either explicitly or by indirection, to under-emphasize the importance of continuing exploration." (118: 15,882, lines 9-11)

However, the record nevertheless would seem to support Dr. Kahn's conclusion that

> "there is certainly no evidence as yet of a threat presently or in the immediate future of inadequate supplies of natural gas." (102: 13,485, lines 3-5)

This conclusion was supported by the following statement made in open hearing by Phillips' counsel:

". . . I wish you would go back and read my opening statement and the statements in the testimony of Mr. Tarner and Mr. Turner in which we all flatly stated that we were not predicting doom for the gas industry or a shortage of gas." (102: 13,487, lines 18-22)

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There is no basis for here concluding that "extraordinary new incentives" are required to produce the necessary levels of exploration and discovery. It is instead concluded that these required levels can reasonably be met if Phillips is here allowed rates for its jurisdictional gas sales which fairly reflect all of its actual jurisdictional costs, including a reasonable and realistic share of its total exploration costs, plus a reasonable and fair rate of return.

Furthermore, the record does not furnish any basis for assuming that significantly higher levels of additions to our present natural gas supply would result from the allowance of jurisdictional natural gas rates exceeding the above standard. The fact is that price itself is not the sole determinant of the level of exploratory effort. In 1955 almost 50 percent of the sales of natural gas to interstate pipelines were made by twenty major integrated oil companies. This means that a very substantial portion of the nation-wide gas supply comes from integrated oil companies, a major portion of whose total revenues are obtained from the marketing of petroleum products. With respect to these companies, the fact of their integration itself gives rise to a special incentive to engage in their own exploration, and to encourage others to explore by the providing of various inducements. These integrated companies have a stake in controlling the sources of the crude oil which they process, in order to protect their enormous investments and commitments in transportation, refining and marketing. (102: 13,481-82)

(31601)

Furthermore, even if it were assumed that price was a major determinant of the level of exploratory effort, the impact of the price of gas alone would inevitably be far less influential than the price of oil, for the reasons already pointed out in detail above. Accordingly, although the increasing demand for and the increasing price of gas in recent years has undoubtedly increased the contribution of gas to aggregate exploratory incentives and funds, *it is still unrealistic to regard the search for gas as an independent or preponderant factor in total exploratory activity.*

Finally, predictions have been made as to the existence of reserves of natural gas still to be discovered in the United States, in the order of approximately one trillion Mcf.[190] The extent of such remaining supplies of natural gas, still awaiting discovery, is fixed ultimately by nature, and not by the price of gas or oil. The gas is there beneath the surface, and its total physical volume cannot be altered or influenced by the price of gas today or in the future. In addition, although the rate and dollar pattern of its discovery will be influenced to some extent by price considerations, the price of oil will undoubtedly play a more important role in such influence than the price of gas. (102: 13,486)

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XX. Phillips' Contention Re Alleged Negligible Impact of Its Recommended Rates

Phillips contends that the rate increases proposed by it in this proceeding would have only a negligible impact, because (1) such increases can easily be totally absorbed by its pipeline customers; and (2) even if this were not the case, the resultant gas prices to be paid by the consumers would still be competitive with other fuels.

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190 See reference by Dr. Kahn to estimates by Terry and Winger of the Chase Manhattan Bank. (102: 13,486)

In support of the first contention, Phillips presented witness Wilhelmi [191] to demonstrate that the continuing depreciation accruals of the pipelines and distribution companies "offer a means for possible absorption of much of the increasing cost of exploration and development". (Phillips initial brief, p. 170) Wilhelmi testified that so long as the pipeline and distribution companies can obtain a constant gas supply, they will have a decreasing cost of service as the result of an increasing depreciation reserve, which under normal operations does not have to be plowed back into the business merely to continue adequate gas deliveries to existing customers; that the amount of this reserve is deducted from the original property investment, so that on a constant volume of gas handled the accrual of the reserve operates to reduce the net investment, thus producing a lower rate base and a lower return component; that the force of depreciation accruals, operating in this manner, "may offset a part, or possibly all of increasing costs of production, so that they may never reach gas consumers." (58: 8155-57) In order to demonstrate this thesis, Wilhelmi presented Exhibit 262 to show

> ". . . how depreciation reserve accruals continually work to reduce the net plant account, and, therefore, the cost of service of natural gas pipeline companies and gas distribution companies.
>
> "It also shows the possible magnitude of those cost reductions, and that they work to keep the price of gas to the consumer down, although gas production costs are going up, so that gas will not necessarily either be priced out of its present markets or make obsolete the

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191 Engaged in various phases of the natural gas business for 35 years, including a period as consultant on the staff of Ebasco Services, Inc., of New York City. Presently engaged in private consulting practice in Shreveport, Louisiana.

gas appliances and equipment of 27 million natural gas users." (58: 8158, lines 2-11)

However, in the course of interrogation by the Presiding Examiner, Wilhelmi later agreed that the conclusions set forth in Exhibit 262 were valid only on the assumption that the pipeline or distribution company's other operating expenses would remain constant during such years, that its utility plant would not be expanded, and that the only problem encountered would be that of increases in purchased gas cost. (58: 8174, line 19; 8175, line 9) The following colloquy then ensued:

"PRESIDING EXAMINER: Is it your contention that the hypothetical assumptions, which are the basis for your exhibit, are realistic assumptions which will obtain in the future?

"THE WITNESS: As I said a moment ago, they may not be realistic assumptions. Operating costs may go down, or they may go up, but in order to find the force of the depreciation accruals, that is what I had to do. That is the only way you could actually compute it and find it.

"PRESIDING EXAMINER: Well, do you go any further, then, with your Exhibit 262, than to indicate to the Commission that if all of those assumptions should obtain in the future years, that the pipeline company then would be able to absorb a purchased gas cost increase without getting an increase in its own rates, but based on those assumptions, that the other costs will remain static?

"THE WITNESS: I don't believe I understand what you mean—Do I go any further than that?

"PRESIDING EXAMINER: You do not—do you take

the position that Exhibit 262 bears any other significance than that as I have just summarized it?
"THE WITNESS: No." (58: 8,175, line 12—8,176, line 8)

Wilhelmi made it clear that these assumptions are *not* realistic, in his responses to later interrogation, as follows:

"Q. Based on your experience as an executive of or consultant for natural gas distribution facilities, can you state what has been the trend of costs of operation, excluding the cost of purchased gas for such operations?

* * * * *

"Q. But the general trend of costs, other than costs of purchased gas, have been up?
"A. The total costs of operations have been upwards.

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"Q. Would not the same cost conditions apply to pipeline operations?

"A. Again, the total cost of operations have been upward. . . ." (92: 12,352, line 22—12,353, line 20)

In the light of current conditions, it certainly is not unreasonable to expect that the operating costs of pipeline companies and distributors may show a net increase in the future, and that their net investment may also show an increase as the result of plant expansion, required to satisfy the increasing market demands estimated by Phillips witness Turner. It is obvious that the magnitude of the rate increases which might be required under such circumstances would clearly be affected by the level of the purchased gas costs which the pipeline companies may be required to pay to their producer-suppliers.

In view of the matters noted above, this particular Phillips contention is not entitled to further serious consideration.

The second type of "impact" presentation made by Phillips consisted of Wilhelmi's Exh. 292, headed "Computation of the Effect of Phillips' Proposed Rate Increases on the Average Prices of Gas if Such Increases Must be Passed on to the Consumer". The purpose of this presentation was to demonstrate that the impact of the rate increases here proposed by Phillips, even if accompanied by similar rate increases to the instant pipeline interveners from other producer-suppliers, would still leave gas competitive with other fuels, and that the resultant purchased gas cost increases would still be within the ability of the pipelines and distributors to recover from their customers. (Phillips initial brief, pp. 170-171) Actually, the Exh. 292 computations are subject to the same defects as those already indicated with respect to Wilhelmi's Exh. 262 presentation. They are of interest only in connection with the entirely unrealistic assumption that other cost factors encountered by the pipeline and distribution companies would in the meantime remain static, so that they would be confronted with no problem except that of increases in purchased gas cost.

Furthermore, the Wilhelmi study is regarded as too speculative and incomplete to be of any real value, for certain additional reasons set forth below. It did not give adequate consideration and effect to the impact of Phillips' proposed rates upon *industrial sales*. This is a vital consideration because when natural gas becomes noncompetitive with other fuels, the inevitable consequence is that the industrial load is reduced, or is lost. This, in turn, reduces the load factor, with the final result that there is an increase in unit cost for the remaining gas transported and sold—*i.e.*, in the rates for residential and house heating uses. When Wilhelmi was asked during cross-examination whether he had made any study as to the impact of the proposed Phillips rate in-

creases upon industrial gas sales in the state of Wisconsin, he replied as follows:

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"A. No specific study, other than to compare the gas prices presently and those that would result with the prices of oil as reported by Platt's Oilgram for Milwaukee, and also the prices of coal that it seemed were being paid up there by the power plants in that area which I believe were probably the lowest anybody buys coal for.

"Q. In other words, you don't know the impact on industrial sales of these rates?

"A. No, there was no public record that I could find of any specific industrial customers that I could use for a basis for making such a study." (92: 12,346, line 23—12,347, line 8)

However, intervener's witness George B. Johnson, Vice-President in Charge of Operations, Minneapolis Gas Company [192], testified that a comparison of gas prices, for this purpose, with the prices of oil as reported by Platt's Oilgram was meaningless, because:

"In determining the loss of interruptible sales, the cost of competitive fuels for industrial uses is extremely difficult to obtain. While the cost of competitive fuels for residential uses may be found in statistical services such as the Bureau of Labor Statistics and Platt's Oilgram Service, as was done by Mr. Wilhelmi, such is not the case with industrial fuels.

"Competitive fuels for large industrial users are generally priced on an individual basis from the supplier to the customer. These bids are usually confidential

[192] A distribution company customer of intervener Northern Natural Gas Company.

and extremely difficult to obtain specific information on. Also one price will exist for a fuel for standby uses and another lower price if the customer will burn the fuel on a 100 percent basis." (100: 13,116, lines 4-17)

The importance of giving proper weight to the impact of Phillips' proposed rate increases upon *industrial* sales was demonstrated by witness Johnson as follows:

"Northern sells a substantial amount of interruptible gas, amounting to about 49 percent of its total sales on an Mcf basis in 1956. Any increase ordered by the Commission to be placed on the commodity rate could well result in the loss of large volumes of interruptible sales on Northern's system. A substantial loss of these sales would greatly affect Northern's unit costs and add to the financial impact on the ultimate consumer.

"In calculating the loss of interruptible sales, it would be necessary to first consider the loss of Northern's direct sales and those of its utility customers. This loss would then be spread over the remaining sales and would result in an increase in the city gate rates.

"Secondly, the loss of revenue to the distribution companies as a result of dropping their own interruptible sales would then have to be considered. Any such losses would have to be recouped by an increase in the distributor's rates." (100: 13,115, lines 5-22)

Wilhelmi himself expressed the same view, as follows:

"The problem that I was trying to present at that particular point in my testimony was that in this area, where gas is being distributed by Northern Natural Gas Company, there might be a substantial impact on the consumer, particularly the residential consumer and

the domestic, or rather the commercial consumer of Phillips' rate increases, because of the fact that Northern Natural Gas Company has a very large interruptible gas load. They have not developed any storage facilities, as far as I know, on their system. Consequently, even with the interruptible gas load that they have, their sales in the summertime are substantially smaller than they are in the winter, and the increases by Phillips, their gas prices, would have an impact on the commodity costs of the gas by Northern which would affect the prices of gas sold to their interruptible customers."

* * * * *

"I also pointed out that some of those interruptible customers were certainly customers of the distribution companies, and it would take a very substantial study to ascertain what all those factors were." (92: 12,350, line 5—12,351, line 3)

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Along the same lines, Wilhelmi also testified:

". . . I tried to get that across, but I missed it, that there is going to be an additional impact on the residential and commercial and industrial gas cost brought about by any loss of interruptible gas business that these distributors may have themselves over and above that that I have been able to estimate I think fairly accurately from the data at hand.
"*I can't do anything with that second range of loss.*" (63: 8864, lines 12-19; emphasis supplied)

It is finally noted that Wilhelmi's Exh. 292 study also fails to reflect in any way certain other possible impact factors, such as:

(1) The effect which a reduction in interruptible load might have upon Northern Natural in view of the increasing amounts of gas which it purchases under "take or pay" contracts. If Northern's requirements, as a result of any such reduction in interruptible sales, should fall below the minimum take provisions of these contracts, the cost of gas paid for by Northern, but not taken, would result in additional unit costs which would have to be spread over its remaining sales. (100: 13,116)

(2) The fact that the ultimate financial impact of such producer rate increases upon distribution companies would vary according to the manner in which purchased gas cost increases to the instant pipeline interveners were subsequently distributed, as between demand rates and commodity rates fixed for the pipeline. To the extent that any such increases were ultimately reflected in the pipeline's *demand* rates, the resultant impact upon its distribution company customers would vary depending upon the latter's load factor. (100: 13,114)

Furthermore, in the exercise of its responsibility to carry out the primary aim of the Natural Gas Act "to protect consumers against exploitation at the hands of natural gas companies",[193] the Commission is concerned with far broader considerations than the impact of the instant decision upon Phillips' own customers. This Commission must consider and weigh the much broader impact which the positions it may here adopt on the major issues in this case (*i.e.*, the allocation of exploration costs between oil and gas, the claimed phantom tax allowance, the rate of return to be allowed, *etc.*) will have upon the over-all regulation of independent producer rates in general—and the resulting ultimate impact of such determinations upon consumers in general.

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[193] *F.P.C.* v. *Hope Natural Gas Co.*, 320 U. S. at 610; *City of Detroit* case, *supra*.

Contemporary history shows that pipeline and distribution companies are being confronted with significant cost increases in many areas, including purchased gas costs; that the cumulative effect of all these factors has been a continually increasing trend of higher prices to the ultimate consumer—with the result that distribution companies in some areas fear that they are already "being priced out of the market", while in other areas this situation appears to be coming closer. There can, of course, be no doubt that the continually rising trend of purchased gas costs represents one of the significant factors which combine to produce this cumulative impact, and it is, therefore, concluded that it is totally unrealistic to consider the potential impact of the Phillips rate proposals in the instant case upon the narrow and artificial basis here suggested by Phillips.

XXI. THE FIELD PRICE PRESENTATIONS IN THIS PROCEEDING

As already noted above, Phillips here takes the position that its jurisdictional rates should be determined upon the basis of its overall *cost of service*. This was made perfectly clear by its policy witness, Stanley Learned, in the following colloquy:

> "Q. Do you wish to have the Power Commission fix your prices by value as you have defined it?
> "A. No.
> "Q. You do want to have it fixed according to a cost of service?
> "A. Yes, sir." (92: 12,481, lines 10-15)[194]

[194] On the basis of its claimed cost of service in this proceeding, Phillips recommends proposed rates ranging from a high of 22.75 cents per Mcf to a low of 16.5 cents per Mcf, depending upon delivery conditions. The maximum proposed rate of 22.75 cents per Mcf is, of course, higher than any of the claimed "commodity value" or "field price" levels presented in this proceeding.

However, Phillips explained that in order to meet the eventuality that the Commission might conceivably determine market price, or field price, to be a proper criteria for the establishment of producer rates, it desired to make a field price presentation. (62: 8675) This presentation was made by Phillips witness Mayer, who took the position that the "going market price" for natural gas in the entire Southwest producing region (including Texas, Oklahoma, Kansas, Louisiana, Arkansas, Mississippi and New Mexico) was "at least 21 cents per Mcf" at 14.65 p.s.i.a. (62: 8755-56) He characterized this 21-cent price as "being representative of prices paid for 1,000-pound, gathered, sweet, dehydrated gas".

He then applied to this 21-cent figure certain price differentials based upon varying delivery conditions and quality.[195] On the basis of these differentials he developed prices for each and every Phillips jurisdictional contract, ranging from a maximum of 21 cents to a minimum of 14.75 cents per Mcf. (Exh. 291; 63: 8770) This claimed 21-cent "going market price" figure is, of course, somewhat lower than the maximum 22.75-cent rate recommended herein by Phillips on the basis of its system-wide cost of service. It will be noted, however, that the Phillips briefs make no reference to this field price evidence, and that Phillips here bases its recommended rates solely upon its claimed cost of service.

On the other hand, Southern presented *and relies on* a major field price presentation, made through its witness Falck,[196] on the basis of which it is contended that the

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[195] These price differentials for varying delivery conditions will be discussed in detail at a later point.

[196] A private consultant in the electric power and natural gas field. Formerly Director of the Office of War Utilities, War Production Board, and later Director of the Office of Energy and Utilities of the National Security Resources Board.

weighted average field price, or commodity value, in 1956, of natural gas produced in the Permian Basin and Panhandle areas [197] was 9.13 cents per Mcf for the Permian Basin area and 9.68 cents for the Panhandle area. (Southern brief, p. 46) Southern takes the position that the rates proposed by Phillips in its Section 4(e) rate filings in the instant proceeding, for the Permian Basin and Panhandle areas [198], represent increases within the range of these "weighted average field prices", and may, therefore, be supported as just and reasonable rates. However, Southern contends that any rates higher than its claimed weighted average field price levels, even if found not to be in excess of the Phillips cost of service, must here be denied. In taking this position, Southern stresses the following conclusion, expressed by its witness Falck:

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> "It is one thing to use an asserted revenue *deficiency* based upon claimed cost of service to bring a producer's price *up* to the average price in the field; it is quite another to use the asserted revenue deficiency for the purpose of raising a producer's price far beyond the prevailing level of field prices". (99: 13,072, lines 1-6; emphasis supplied)

In view of the conclusion reached in this decision that Phillips' over-all unit cost of service amounts to 11.662 cents per Mcf, a level somewhat higher than Southern's claimed weighted average field prices of 9.13 cents for the Permian Basin area and 9.68 cents for the Panhandle area, it is necessary to deal briefly here with this theory as ex-

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[197] Which constitute the source of a major portion of the natural gas supply for this intervener group.

[198] Running from 6¾ cents-8¾ cents per Mcf for the Permian Basin area, and 11 cents per Mcf in the Panhandle area.

pounded by Southern. That theory, in effect, amounts to a contention that although the doctrine of the *City of Detroit* case, *supra*, requires that the traditional rate base method must be used as a point of departure where the field price levels sought by the producer are *higher* than the determined cost of service rates, nevertheless where such field price levels are *lower* than the determined cost of service rates the lower field price levels should be treated as controlling.

It is concluded that this is an unjustifiable position. It is true that the Court of Appeals in the *City of Detroit* case, *supra*, refused to agree that the field price method could not under any circumstances be used in arriving at "just and reasonable" rates. However, the Court clearly did not hold that the Commission is *compelled* to treat field price levels as controlling for this purpose. The most that can be said about the *City of Detroit* decision in this connection is that it upholds the discretionary power of the Commission to consider field price evidence *as one of the factors* in arriving at its decision, provided that certain important basic requirements laid down by the Court are observed. Any failure in this proceeding to allow Phillips the opportunity to recover rates sufficient to recoup its proper cost of service as here determined, would be inherently unfair and contrary to the public interest. It might also raise a serious question with respect to possible violation of the constitutional prohibition against confiscation.

For reasons which will later appear, it would be helpful and instructive at this point to direct our attention to a brief review of the various types of field price evidence which were presented in this proceeding, as follows:

(1) *The Phillips Field Price Presentation.* Phillips witness Mayer derived his alleged 21-cents per Mcf "going market value" for all Phillips jurisdictional natural gas sales on the basis of five selected, high-priced contracts ne-

gotiated in 1954, 1955 and 1956 in the South Louisiana area—buttressed, after some interrogation by the Presiding Examiner, by a reference to the fact that Natural Gas Pipe Line Company of America, in a proceeding then pending before the Commission, was "proposing to pay 29 cents per Mcf for the delivery of gas of pipeline quality and at pipeline pressures, at Beatrice, Nebraska". (62: 8759, lines 15-20; emphasis supplied) This delivery point was 400 miles from the Texas Panhandle,

which is the center of the Panhandle-Hugoton field. When interrogated further by the Presiding Examiner, Mayer agreed that during the past two or three years contracts have been negotiated between pipelines and producers in the Texas area, for example, at price levels lower than 21 cents per Mcf; that he had, in fact, not examined all of those lower-priced new contracts for the purpose of determining whether they were in fact subject to conditions, which under his own standards, would render them non-representative of true "going market value"; that he accordingly could not say that those lower-priced contracts should not also be considered and given appropriate weight. (63: 8777-8778) Mayer finally summed up his position as follows:

> "Now, the price that is paid for gas may be affected by a great many things, but what I was trying to show was that to at least five different pipelines, gas was worth 21 cents under the conditions of delivery of those five contracts." (63: 8778, lines 12-15)

It is thus obvious that Mayer's 21-cent figure cannot even be regarded as an average of the prices negotiated *in recent years* under newly executed contracts in the areas where Phillips' production occurs.

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An alleged "field price" figure based exclusively on the meager evidence just summarized could not possibly be given serious consideration under any serious field price approach. Since it is here concluded that it has not been established by any persuasive evidence in this record that Mayer's 21-cent per Mcf figure truly represents the "going market price" for natural gas in the Southwest producing region, the suggestion that Phillips' claimed unit cost of service of 22.75 cents per Mcf is really not unrealistic or startling, in that it is quite in line with the alleged "going market price" of 21 cents for natural gas in the entire Southwest, becomes quite meaningless.

By contrast, Eastern's field price witness, Dr. Joskow,[199] made a comprehensive study of all prices paid by interstate pipelines under gas supply contracts newly negotiated in 1954, 1955 and 1956 in the Panhandle-Hugoton, Permian, West Texas, and Gulf Coast areas. This study disclosed that interstate pipelines paid a weighted average price in these areas of 11.11 cents per Mcf for 1954 deliveries under contracts executed in 1954, 12.78 cents for 1955 deliveries under contracts executed in 1955, and 13.47 cents for 1956 deliveries under contracts executed in 1956. (Exh. 387, p. 3, 100: 13,195)

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Finally, as noted above, Southern witness Falck presented a comprehensive study of all prices paid by interstate pipelines in the years 1954, 1955 and 1956 for all purchased gas, without regard to the date of the contract, covering production from the Permian Basin and Panhandle areas. Based on this study Falck arrived at 1956 "weighted average field prices" as follows: (1) for the Permian Basin area, 9.13 cents per Mcf for gasoline plant outlet purchases

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[199] Assistant Professor of Economics at City College of New York, also employed as Research Director of the private consulting firm of Boni, Watkins, Jason and Co., Inc.

(residue gas), and 9.45 cents for wellhead purchases (raw gas); (2) for the Panhandle field, 9.68 cents for gasoline plant outlet purchases, and 10.66 cents for wellhead purchases. (Exhs. 378 and 379)

As earlier noted, it is here concluded that Phillips' unit cost of service amounts to 11.662 cents per Mcf. It has already been concluded above that it would be improper to here deny to Phillips the opportunity to recover its jurisdictional cost of service, as thus determined. At the same time, for reasons which will now be set forth, it has also been concluded that rates in excess of those derived from such unit cost of service are not warranted in this proceeding. Accordingly, no purpose would be served by attempting to determine here what would be an appropriate field price level in the event that rates were here to be fixed on the basis of a field price approach.

As already set forth in detail at an earlier point, it is here concluded: (1) that the required levels of exploration and discovery can and should be met if Phillips is allowed rates for its jurisdictional natural gas sales which fairly reflect all of its actual jurisdictional costs, including a reasonable and realistic share of total exploration costs, plus a reasonable and fair rate of return; and (2) that the instant record does not furnish any basis for assuming that any significantly higher level of additions to our natural gas supply would result from the allowance of jurisdictional natural gas rates exceeding the above standard.

In the *City of Detroit* case, *supra*, the Court of Appeals held that the Commission may, under the Natural Gas Act, give consideration to the need for encouraging exploration and development of gas resources "at least to the extent of allowing recovery of development and exploration *costs*." However, the question as to whether the Commission may properly go further than merely allowing recovery of development and exploration *costs* was left undecided by the Court, because of its conclusion that disposition of the ap-

peal on the record then before it did not require the resolution of that question. (230 F.2d at 817) The court further held that use of the field price method can be justified only in terms of a demonstrated public interest; that the allowance of an amount found necessary to encourage exploration and development of gas resources could actually be included without resort to the field price approach; but that if the field price method were

used for this purpose, the evidence and the findings must show that the increase in rates thus caused (over and beyond the amount calculated under the traditional rate base method) would be no more than reasonably necessary for the purpose of encouraging the required levels of exploration and development.

In view of the basic conclusions reached herein, as outlined above, it is impossible to make the required finding in this proceeding that the difference between the rates herein computed on the cost of service basis, and any higher field price levels, would constitute an amount "reasonably necessary" for the purpose of encouraging the required levels of exploration and development; or that *any amounts* in excess of the rates herein computed are "reasonably necessary" for such purposes.

XXII. SYSTEM-WIDE RATES vs AREA RATES

One of the major problems which must be resolved in connection with the regulation of independent producer rates is the question whether such rates should be fixed on the basis of a system-wide, uniform rate approach, or on the basis of an area-pricing approach.

Phillips here uses a system-wide, uniform rate approach, under which it proposes schedules of uniform rates for all customers, based upon its system-wide cost of service, with

rate differentials to reflect four different delivery condition factors.[200] Under this method Phillips witness Mayer established a top price for gathered, high-pressure, dehydrated and treated gas of 22.75 cents per Mcf. Applying the various differentials to each separate delivery, he derived recommended rates for each contract, with prices varying from the top of 22.75 cents per Mcf to a low of 16.5 cents per Mcf. (Exh. 324)[201]

The Staff and the interveners in this proceeding attack the system-wide rate approach, and advocate instead an area-pricing approach. However, there is a wide area of disagreement between the Staff and th various interveners as to the manner in which an area-pricing approach should be applied. Eastern takes the position that area prices should

be developed on the basis of a system-wide cost of service, and not by constructing a separate cost of service for each Phillips producing area. The Staff and other interveners, however, insist that a separate cost of service must be developed for each producing area. In addition, there are other differences which will shortly be outlined in detail.

A. *The Staff's Area-Pricing Method*

The general problems inherently arising under any area-pricing method based upon a separate cost of service for each area will be discussed somewhat later. At this point attention will be directed to the particular defects in the Staff's method.

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[200] These four rate differential factors were (1) point of delivery, (2) pressure, (3) whether dehydrated or undehydrated, and (4) whether sweet or sour. These factors will be discussed in detail at a later point.

[201] With the exception of certain categories of rate schedules as to which Phillips here recommends that no rates should be fixed. This problem will be discussed at a later point.

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Staff cost of service witness Vaught determined Phillips' costs "on the basis of the six areas that Phillips maintains on its books for the purpose of accounting for the operation of its total over-all properties." (48: 6,902, lines 22-24) He described these as "accounting areas maintained by Phillips in its accounting for costs." (48: 6,903, lines 6-7)[202] Vaught's six "areas" were designated: (1) Hansford, (2) Sherman, (3) Borger, (4) Pampa,[203] (5) Permian Basin, and (6) Miscellaneous. However, Phillips witness Cramer testified that these six different so-called areas were actually not geographical areas at all, but merely accounting summaries maintained in Phillips' Natural Gas Department. The Staff made no attempt itself to obtain any knowledge as to what was actually encompassed in these so-called "areas." Staff witness Munn stated:

> "These were strictly bookkeeping areas that we followed for convenience."
>
> "MR. TORKELSON: They were bookkeeping areas that were used by the company?
>
> "THE WITNESS: By the Company, yes, in setting up their books.
>
> "MR. TORKELSON: Do you know the basis on which the company has set up these various areas?
>
> "THE WITNESS: No." (42:6300, line 22—6301, line 5)[204]

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It was made quite clear that these so-called "areas" have no real geographical significance, in the following testimony by Phillips' witness Cramer:

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[202] Exh. 208.

[203] All in the Panhandle region.

[204] Also see similar statement by Vaught, at 48:6902, lines 8-9, and by Staff witness Crosby, at 55:7729-31.

"These six different so-called areas are not geographical areas. They are merely accounting summaries. For example, the Sherman and Hansford areas, as shown on the statements of Phillips, constitute the gathering systems serving the Sherman and Hansford gasoline plants. These two plants are located side by side, and the geographical areas served by the systems connecting these two plants are in some instances over-lapping.

"What has been referred to as the Permian Basin area constitutes all gathering systems located in the Permian Basin production area of west Texas and New Mexico. There are a number of systems in that area, most of which are widely separated, and not connected with each other.

"However, wellhead sales of gas from leases located in the Permian Basin producing area are included in the miscellaneous summary.

"Q. What else is included in the miscellaneous summary?

"A. That accounting summary includes everything else not included in the other five. It is a combination of gathering systems and wellhead sales. It includes all gathering systems not included in one of the other five accounting summaries, and all wellhead sales except those included in Borger and Pampa summaries.

"Q. In summarizing wellhead sales under Miscellaneous, is any geographical significance given to the location of the wellhead sales?

"A. No. As I stated, this accounting summary includes all wellhead sales except dry gas wellhead sales located in the Borger and Pampa operating areas. For that reason, many of the wellhead sales included under Miscellaneous are located in the same geographical area as system sales included in one of the other accounting summaries. The absence of any geographical significance is shown by the fact that the four accounting

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subdivisions of Hansford, Sherman, Borger and Pampa relate to gas produced and purchased in only nine counties, and the Permian Basin accounting subdivision relates to gathering systems in nine other counties.

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"The Miscellaneous subdivision not only includes everything else in the United States outside these 18 counties, but also includes wellhead sales located within some of these 18 counties." (59: 8,260, line 1—8,261, line 15)

In addition to the matters outlined above, the Staff's use of these accounting summaries maintained in Phillips' Natural Gas Department ignores the fact that Phillips' Oil and Gas Production Department, which has responsibility for all casinghead and condensate gas production in all areas, is organized by districts which do not correspond to these accounting summaries of the Natural Gas Department. This problem did not concern Staff witness Vaught, in view of his technique of determining the unit cost of casinghead and condensate gas by simply imputing to those products the unit cost of producing dry gas in the entire Panhandle-Hugoton field. However, as noted at an earlier point, it resulted in assigning to casinghead and condensate gas the dry gas production costs for the shallow Panhandle and Hugoton fields, representing the lowest dry gas production costs on the Phillips system, and that technique is here rejected as totally unacceptable for the purpose of this proceeding.

The next step in the Staff's area-pricing approach was taken by its rate witness Crosby,[205] in his Exhibits 215 and 215-A. For pricing purposes, Crosby combined witness Vaught's four areas in the Panhandle region (Hansford, Sherman, Borger and Pampa) into one Panhandle area.

[205] A Staff rate engineer, associated with the Commission since 1939.

His second pricing area was the Permian Basin area, and his third was the Miscellaneous area. However, he further subdivided the Miscellaneous area into seven smaller units based upon the operating districts of the Oil and Gas Production Department. Crosby's rationale for grouping the four Panhandle areas for rate purposes was as follows:

> "Because they are contiguous, because gas was exchanged among them, because Mr. Vaught has used the average cost of dry gas for these four areas for imputing cost to casinghead gas, and because Phillips' present prices in some cases transcend the various areas." (45: 6,610, lines 16-20)

It is interesting to note that the Staff (pp. 32-33 of initial brief) attacks the system-wide rate approach as

> "a total disregard of operating conditions within historically known producing areas; a total disregard of the wide difference in costs incurred in producing and selling gas as between areas in Phillips' system. . ."

However, an analysis of the three basic Staff pricing areas (Panhandle, Permian Basin and Miscellaneous), as thus applied by the Staff, discloses that they actually do not truly reflect cost differences between different producing areas at all:

(1) The Panhandle area, as used by the Staff, consists of the average costs of the four areas designated Sherman, Hansford, Borger and Pampa. However, since average costs were used, the only difference in the Staff's recommended rates within these four areas reflects differences in delivery conditions, and not differences in cost. The explanation given by Staff witness Crosby for his combining of these four areas into one group, quoted above, did not

include any contention that costs in all four of these areas were relatively similar.

(2) The average dry gas production cost in these same four areas was also used by the Staff to determine its imputed cost for casinghead and condensate gas produced in all areas, so that admittedly any differences in operating conditions and cost levels as between different areas was completely ignored by the Staff in determining its proposed rates for casinghead and condensate gas.

(3) The only portion of Phillips production included in the Staff's Permian Basin area consists of casinghead and condensate production transferred to the Phillips gathering systems. Since the Staff's imputed dry gas cost was applied to this production, the same average production costs for the Panhandle area, referred to above, are thus also used by the Staff in the Permian Basin area—with differences in gathering costs creating the only difference in recommended rates.

(4) It thus appears that the recommended rates in two of the Staff's three basic areas are derived from the same average production costs, and in effect constitute the same rate for both areas, adjusted only for delivery conditions.

(5) The Staff's third basic area, Miscellaneous, includes both sales of dry gas and sales of casinghead and condensate gas. As to casinghead and condensate gas, the recommended rate is based upon the same imputed cost used in the Panhandle and Permian Basin areas.

In addition, the Staff method created certain other disturbing problems. Under this approach, the Staff derived an average cost of 36.72 cents per Mcf for wellhead sales of dry gas in its Miscellaneous area. Because of Staff recognition that Phillips could not realistically be expected to sell this gas at any such price level, Staff witness Crosby adopted the position of not recommending any rate at all

for these particular sales. (45: 6,612, 6,617; Exh. 215, Sheet 13, footnote 5) At the same time, however, the Staff took the position

that each "area" would have to stand on its own feet; that accordingly any deficiency resulting from such sales in the Miscellaneous area at prices substantially below the 36.72 cent figure could not be made up by a corresponding increase in the rates authorized for sales from other areas, and that Phillips would therefore be "stuck with a loss." (45: 6,621, lines 17-19; 6,619-21) At the same time, although thus requiring Phillips to absorb any such deficiency from these sales in the Miscellaneous area, the Staff position, as advanced at the hearing, would have required the *reduction* of Phillips' current rates for certain types of sales in other areas.

This completely untenable position has now been abandoned in the Staff brief (pp. 144-145 of initial brief), where it is recommended that this problem be resolved as follows. With respect to dry gas sales in the Miscellaneous area, it is now recommended that Phillips should be permitted to charge the highest rate which it was receiving as of July 1, 1956 for any similar sales of gas made in these respective areas. The Staff then recommends that the remaining deficiency should be distributed volume-wise against all of Phillips' sales in other areas. On the basis of the Staff's cost of service, this would require the addition of a further charge of 0.67 cents per Mcf to the rates derived by the Staff for each other area. To this extent, it is of course obvious that the rates finally proposed by the Staff herein for each of its pricing areas would not technically represent true area rates at all.

For the reasons outlined above, it is here concluded that the area-pricing approach presented by the Staff in this proceeding is not acceptable.

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B. *The General Problems Inherent In An Area-Pricing Approach Based Upon a Separate Cost of Service For Each Producing Area*

As already noted above, although the Staff and the interveners attack the system-wide rate approach and advocate the adoption of an area-pricing approach in this proceeding, they differ substantially among themselves as to the manner in which an area-pricing approach should be applied. As a matter of fact, although interveners Southern, Pacific, Wisconsin, El Paso, and Panhandle seem to advocate the adoption of an area-pricing approach based upon a separate cost of service for each of Phillips' producing areas, they have not indicated how such area rates, in their view, should be constructed. As further evidence of the confusion and disagreement between these parties as to how an area-pricing approach should be applied, it is of interest to note the conflicting positions taken by the Staff on the one hand, and the interveners on the other with reference to the manner in which exploration costs should be assigned to the different areas. The Staff allocates exploration costs between its proposed areas on a "volume of production basis"—

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> "by allocating on the basis of the Mcf produced in each area. This method of allocation gives weight to the production in each area." (initial brief, p. 36)

Actually, the Staff thus treats exploration costs on a company-wide basis, instead of allocating such costs to its selected areas on the basis of the incurrence of those costs in each area. This, of course, represents a still further departure on the part of the Staff from a true area-pricing approach, since the volume of production in each area actually has little, if anything, to do with the actual incurrence of exploration costs in such area, or with the relative benefits

received by such area from the exploration activity involved.

On the other hand, the interveners (with the exception of Eastern) argue strenuously that they should not be required to pay the cost of any exploration which will not be of immediate, direct benefit to them. They accordingly contend that customers purchasing Panhandle and Hugoton gas should not be charged with any of the costs of other areas. This attitude was sharply high-lighted in the course of Staff counsel's cross-examination of Southern witness Chapin. Chapin's attention was here directed to the area designated by him as the Rocky Mountain area (Exh. 361). Staff counsel suggested a hypothetical situation in which the exploration costs expended in that area were very high, but the volume of gas currently produced therefrom was relatively small, with the result that Phillips in order to recoup its expenditures for the test year would have had to sell all gas produced from that area at 54 cents per Mcf. Since there would, of course, be no market at that price, the hypothetical question assumed that Phillips would incur a substantial deficiency on such sales. Chapin was then asked whether, under his theory, Phillips should be required to absorb such a deficiency until production and sales from that area had increased to the point where the gas could be sold for a price commensurate with its unit cost. Chapin replied:

> "Well, I would expect Phillips to sell the gas at the best price it could get and that would be approved by the Commission, or else to cap the well and save it until they could get a better price. I don't know which course of action it should take." (110: 14,663, lines 20-24)

However, somewhat later Chapin modified this position as follows:

> "If it is in the public interest that the gas be sold, rather than capped and saved for a better market—and I assume it would be so determined in the public interest—then there must be some way determined for Phillips to recover that cost. It seems to me an equitable way can be determined, but I have not made any effort to do so in this Exhibit." (10: 14,669, lines 4-9)

It is interesting to note, however, that the Southern brief (pp. 33-34) while stressing the Chapin recommendation that customers buying Panhandle and Hugoton gas should not be required to pay the higher costs associated with gas produced in higher cost areas, makes no mention whatsoever of the Chapin qualification referred to above.

Among other things, the use of an area-pricing approach based upon a separate cost of service for each producing area is regarded as unsatisfactory for the following reasons:

(1) One of the arguments most stressed by the parties favoring an area-pricing approach is that different producing areas each have different cost levels of their own, and that separate rates should, therefore, be fixed for each area reflecting such varying cost levels. However, the persuasiveness of this argument is diminished when it is recognized that a substantial portion of the costs which have to be assigned to each separate area actually do not represent direct area costs which are clearly identifiable as such, but instead represent over-all, system-wide costs which must therefore be allocated between the different areas on one basis or another. Accordingly, although under this area-pricing approach it would still be necessary to conduct a separate rate proceeding for each individual producer, each

such proceeding would become more complicated in that it would require the development of a multiplicity of different area cost-of-service studies for the individual producer. With respect to each of these different area cost-of-service studies it would become necessary, in addition to the various allocation problems already discussed in this decision, to make further allocations for the purpose of assigning the appropriate portion of system-wide costs to each of the different areas, and the results obtained would, of course, depend upon the method adopted for the making of such further allocations.

(2) The area-pricing approach would also add to our task the problem of selecting logical and meaningful costing or rate areas in each producer rate case, with results varying significantly on the basis of the costing or rate areas selected. This question alone would provide the basis for substantial controversy.[206]

(3) If such an area pricing approach were adopted it would not eliminate the situation, criticized by some, under which a given pipeline purchasing gas from a number of different producers in the same field would be paying a different price to each different producer for the same type of gas, depending upon the cost of service established

for each. It is true that the cost of service developed for any producer, including Phillips, in a high-cost producing area would normally be higher than the cost of service for the same producer in a low-cost area. However, this does not mean at all that the Phillips cost of service in any given area would necessarily be the same as that of another producer for the same area. The fact is that the same factors which result in two different producers having a different

[206] See, for example, the attack made upon the "pricing areas" used by the Staff in the instant proceeding.

system-wide cost of service would similarly result in each showing a different cost of service for any given area.

(4) It is also important to note that, apart from the Staff area-price presentation which is here found unacceptable, the instant record does not contain the evidence required to develop area rates on the basis of a separate cost of service for each producing area. This is true despite the fact that all parties desiring to develop area rates on this basis were provided with all reasonable opportunity to do so in the course of the lengthy hearing.[207] It is, therefore, clear that in order to fix rates in this proceeding on the basis of an area-pricing approach, based upon a separate cost of service for each area, it would become necessary to reopen the record and to now embark upon a new hearing of indeterminate duration, directed to this particular problem. Such a reopened hearing would not be a brief and simple proceeding, since the development of costs on a real area basis would require the redevelopment, from a totally different approach, of many of the major problems which have already been fully tried out in this proceeding on a system-wide basis.

C. *Eastern's Area-Pricing Proposal*

As previously noted, Eastern contends that the Phillips cost of service in this proceeding should be determined on a system-wide basis, and not upon an area basis. In this connection, Eastern states:

> "While Phillips and the Eastern Seaboard Companies have presented sharply differing cost-of-service studies (Exhibits 282 and 388), there is no difference between

[207] As set forth in detail at pp. 2-5 of this decision, the requests made by Wisconsin and the Staff, in the closing stages of the hearing, for a recess of indefinite duration to permit them belatedly to gather and present additional and different area cost data, were clearly unjustifiable and not in the public interest.

them as to the soundness and practicability of determining the Company's jurisdictional costs on an overall or company-wide basis.

"We are aware of the fact that some parties to this proceeding contend that Phillips' rates should be

determined on the basis of its separate costs of service in individual producing areas. Such a contention, of course, presupposes that these particular producing areas can first be established on some meaningful and reasonably non-controversial basis. The record in this proceeding fails to support the propriety of subdividing arbitrarily a reasonable and manageable costing area, large though it may be. Especially is this so when we realize that a very substantial portion of Phillips' total costs is incurred in its nation-wide exploratory activity." (initial brief, pp. 17-18)

However, Eastern proposes that once Phillips' total revenue requirements have thus been determined on the basis of a system-wide cost of service, they should be translated into area rates in a new and second step of the proceeding. The Eastern suggestion as to how this objective might be accomplished was made for the first time by its witness Caplan in the closing stages of his cross-examination. Caplan urged that any general rate adjustment should be accomplished with the least possible disturbance to existing market relationships, and he stressed the importance of preserving existing contract arrangements and existing contract prices to the fullest extent consistent with sound regulatory objectives. He suggested that a simple way to accomplish this objective would be to permit the addition to each individual contract rate of a uniform percentage or cents-per-Mcf adjustment, across the board, sufficient to

return to Phillips the full amount of any deficiency determined in this proceeding. (117: 15,748-50; 15,753-54)

When asked whether he would recommend the application of such an adjustment differential to contracts entered into in recent years at rates as high as 15.65 cents per Mcf, as distinguished from contracts entered into many years ago at rates as low as 3 cents or 4 cents per Mcf, Caplan at first replied:

> "Well, it would be a simple way of doing it but I would like to add that I am dealing mainly with old gas, rather than new gas. I recognize that new gas is a separate problem." (117: 15,751, lines 1-3)

However, he then proceeded to explain that he was proposing this method only for application to those contracts which were in effect in 1954, stating:

> "Q. Would it follow, then, that you would apply 3 cents across the board on all contracts, we will say, in effect at the end of 1956, in order to recoup to Phillips any any increase in revenue?

> "A. No; I think you would have to start with the 1954 contracts for this purpose, and treat the contracts entered into after 1954 separately.
>
> "Unfortunately, I have no advice to give on the contracts entered into after 1954. I was only trying to deal with this structure of rates of the test year." (117: 15,751, lines 11-20)

Caplan expressed the view that any such proposals as referred to above should be initiated, in the first instance, by directing Phillips itself to file recommended rates designed to yield the total cost of service here determined, prepared in the light of its existing contractual relation-

ships and the existing market situation. This suggestion was based upon the assumption that Phillips is in close and intimate contact with its customers, and is therefore in the best position to understand the effect of any price changes on market relationships. (117: 15,749-50; 15,754)

The rate proposal as thus made in Caplan's testimony has since been somewhat refined in the initial brief submitted by Eastern, where the final recommendation is now made as follows:

(1) Eastern argues that historic market arrangements and differences in price levels should be disrupted as little as possible, but that at the same time there should be eliminated the distorting effect of favored nation and spiral escalations which took place since 1954.

(2) Eastern accordingly recommends that the Commission should instruct Phillips to file rate schedules designed to meet these objectives. In this connection, Eastern states:

> "A rate structure so approved and filed would not become effective, of course, until approved by the Commission. All interested and affected parties would have a chance to be heard and criticize it.
>
> "While it might be argued that this would perhaps require a second or rate-making phase of this already protracted proceeding, we believe it offers the most reasonable solution to a difficult problem." (Eastern initial brief, p. 56)

(3) Finally, Eastern suggests that, in the event the Commission should consider it desirable to establish rates in this proceeding without the benefit of such further suggestions by Phillips, then area prices should here be established by spreading any rate increase herein approved, over and above the Phillips rates lawfully in effect in 1954, among all of Phillips customers, on either a flat cents-per-

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Mcf or a percentage increase per Mcf basis, applied to June 7, 1954 prices. By way of illustration, it is suggested:

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> "For example, if the Commission determines that Phillips requires additional revenue equivalent to one cent per Mcf, or, say 10 percent above 1954 levels, a possible simple, direct and appropriate procedure would be to increase such contract prices by, as the case may be, either one cent per Mcf or by 10 percent." (initial brief, p. 57)

Eastern did not spell out in any further detail the manner in which it would apply this "area-pricing" approach, and made no presentation to indicate the contract prices which would result from the application of this method to the cost of service computed by it in this proceeding. However, the proposed method may be characterized as providing for a separate rate to be fixed for each jurisdictional contract on the basis of (a) *a base price*, consisting of the contract price as of June 7, 1954, plus (b) a uniform increment, determined either on a flat-cents-per-Mcf or a percentage basis, derived by distributing the total deficiency equally over the entire volume of jurisdictional sales.

The Caplan proposal would seem to have a certain superficial attractiveness, at first blush, for those who are impressed with the argument that any rates fixed for an independent producer should in some way reflect differing cost levels between one producing area and another. It would also seem to be attractive to those who are impressed with the suggestion that such rates should not be permitted to disturb, any more than is absolutely necessary, the pricing patterns and market arrangements which Phillips' pipeline customers have built up over the years, based upon the purchased gas costs which they have historically incurred. The initial attractiveness of the Eastern proposal lies in

the fact that, in a rather minor way, it makes a nod in the direction of both of these problems.

However, upon more careful analysis, it appears that this method actually is neither a system-wide cost method nor an area cost method, and that its disadvantages in fact outweigh the advantage of its seeming simplicity. It is true that the Eastern method would result in and perpetuate widely different rate levels as between one contract and another. However, such rate level differences would not actually reflect the differences in *cost* as between the gas delivered under the various contracts. Instead, it would simply freeze and continue in effect the price differences between the various Phillips contracts which had come into being by June 7, 1954, not necessarily or only as the result of *cost* differences, but because of such other factors as: (a) industry circumstances prevailing when the different contracts were negotiated; (b) what the traffic would bear when each contract was negotiated; (c) the impact of favored nation and spiral escalations. In addition, under the Eastern method there would now

be added to these different contract price levels (based upon such historic, non-cost factors) a system-wide incremental factor, which would in itself be derived on the basis of a system-wide cost of service. It is interesting to note, in this connection, that Eastern itself states

> ". . . it is our position that the Commission should fix Phillips' rates with a view to the establishment of a meaningful overall rate structure which can be equitably applied to the Company's entire jurisdictional business—thus avoiding the gross distortion of existing price relationships and the severe inequity that would result from the application of any rate-making theory which would recognize and incorporate the favored nation concept." (initial brief, p. 55)

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However, the Eastern method, for the reasons outlined above, would clearly not accomplish this objective. It would freeze in and perpetuate the distortions in price relationships *as they existed on June 7, 1954*, including some relatively high price levels resulting from the impact of favored nation escalations which had already become effective by that date. The only distortions which would in fact be eliminated under the Eastern method would be those which had become effective *after* June 7, 1954.

It is also of interest to note that many of the June 7, 1954 prices under Phillips' jurisdictional contracts were at levels substantially in excess of the system-wide unit cost of service determined for Phillips in this decision. The effect of here adopting Eastern's area-pricing proposal would be to freeze such excessive June 7, 1954 rates as the "base price factor", and to raise them still higher by adding thereto the uniform increment required to recoup Phillips' over-all deficiency. In such situations, the total rate thus approved for some contracts under the Eastern method might be even higher than the rate which would have been derived for such contracts on the basis of constructing a separate cost of service for each producing area.

In an earlier part of this decision, it was concluded that the required Section 5(a) determination, under the standards laid down by the Supreme Court in the *Sierra Pacific* case, *supra*, should be made here, on the ground that there otherwise would be preserved for Phillips an unduly discriminatory general rate structure, which would be contrary to the public interest—i.e., a rate structure including prices which as of June 7, 1954 ranged from a low of 1.1710 cents per Mcf to a high of 15.6509 cents per Mcf. (Exh. 323) The Staff's reply brief argued strongly in this connection that the Phillips contract

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rates vary so widely, even as between contracts for the same service from the same producing areas, as to patently

contravene the public interest, generating and perpetuating undue preference and undue discrimination; that this resulted in a rate structure completely adverse to the very principles and purposes of the Natural Gas Act.

However, under Eastern's area-pricing method the result would be to permanently freeze in and perpetuate such distortions, in a manner going far beyond the situation which would have prevailed in the absence of Federal Power Commission regulation of the independent producers. In the absence of such regulation, Phillips' old, long-term contracts with abnormally low prices, which were still in effect as of June 7, 1954, would ultimately have expired, and its pipeline purchasers would then have been required to renegotiate such contracts at higher price levels in line with the then prevailing price levels in the particular producing area —or, in the case of contracts containing escalation clauses, the contract price might well have escalated to the prevailing price levels of the area even before the expiration of the contract terms. Under the Eastern method, however, these particular contracts would have their *base price* frozen permanently at the abnormally low price level in effect on June 7, 1954, even though that price may have been substantially out of line with the currently prevailing price level for the area at that time.

Entirely apart from the problems outlined above, it must be borne in mind that Eastern's area-pricing method was presented only sketchily, at the close of Caplan's cross-examination. It raises many problems which Caplan himself testified had not yet been worked out in his own mind—i.e., the problem of contracts entered into after 1954, as to which Caplan stated:

> "Unfortunately, I have no advice to give on the contracts entered into after 1954." (117: 15,751)

If the method were to be given further consideration in this proceeding, it would certainly require more extended pres-

entation and development than that so far provided. As a matter of fact, Eastern itself recommends that if this approach is to be adopted it should be initiated by Phillips itself filing recommended rates which all interested and affected parties would then have an opportunity to consider, evaluate and criticize in a second or rate-making phase of this proceeding.

For reasons which will be outlined in greater detail at a later point, it is concluded that the public interest would not be served by throwing the instant proceeding back into another hearing phase of unlimited duration. For this reason, and for the other reasons outlined above, it is concluded that Eastern's area-pricing approach does not provide a useful solution for the rate-making problems involved in this proceeding.

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D. *The Phillips System-Wide Rate Approach*

As noted at an earlier point, Phillips here uses a system-wide rate approach under which uniform rates are proposed for all customers, based upon its system-wide cost of service, with rate differentials to reflect four different delivery condition factors.

Interveners such as El Paso and Panhandle, and the distribution company customers whom they supply, contend that a major portion of their gas supply from Phillips comes from relatively low-cost producing areas, such as the Panhandle-Hugoton field; that they do not now and do not expect in the future to derive any benefit from Phillips' high-cost exploration and production in other areas such as the South Louisiana area; that they accordingly should not be required to incur the burden of any of these "other area" costs except with respect to gas which they may in fact purchase from such areas. Southern witness Chapin stated this position as follows:

". . . it is obvious that customers buying Panhandle and Hugoton gas which has been developed at relatively low cost, should pay accordingly lower prices.

"When, as and if these or any customers purchase additional gas from other higher cost areas now being explored and developed, they should properly pay the higher costs associated with that gas. No such distinction is provided in the uniform rate plan proposed by Phillips." (96: 12,787, lines 17-24)

Although it may be true that most of the gas supply currently purchased by interveners El Paso and Panhandle Phillips comes from the lower-cost Panhandle and Permian Basin areas, the fact is that the higher cost exploration and production carried on by Phillips in the Southern Louisiana area redounds ultimately to the benefit of El Paso and Panhandle. This is because the discovery of additional gas reserves in other areas, even if El Paso and Panhandle were never in the future to take delivery from such areas, would have the effect of improving the total nation-wide reserves and thus reducing the pressure upon the existing reserves from which El Paso and Panhandle currently draw the major portion of their gas supply. In addition, the fact is that because of the interrelation of lines and the multiple possibilities of exchange, pipeline companies may receive benefits from new supplies developed virtually anywhere in the United States.

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Entirely apart from the above, however, El Paso itself has been laboring under a substantial gas supply problem which has already required it to obtain new sources of supply in other, higher-cost areas. In recent orders the Commission has stressed the importance of El Paso's continuing

its efforts to improve its over-all reserve position.[208] In order to solve this problem, El Paso has been engaged in recent certificate proceedings before this Commission seeking authorization under Sec. 7(c) of the Natural Gas Act to purchase substantial additional gas reserves: (1) from producers, *including Phillips,* in the Aneth Field area, in the vicinity of the boundary point connecting the states of Utah, Colorado, New Mexico, and Arizona, at contract prices ranging as high as twenty-cents per Mcf for residue gas [209]; and (2) from producers, *including Phillips,* from the Bell Lake Field in New Mexico, at contracts carrying an initial price of sixteen cents per Mcf.[210]

It is also relevant to note, in the same connection, that Panhandle already obtains a substantial portion of its gas supply from the South Louisiana area, through its wholly-owned subsidiary Trunkline Gas Company.

The adoption here of a system-wide rate approach would have the effect of holding down to more modest levels the prices which El Paso and Panhandle would be required to pay for such new gas supplies. Thus, although the application of a system-wide rate approach in this proceeding would have the effect of increasing the prices to be paid by El Paso and Panhandle under their old, low-priced contracts, this would be counterbalanced by the limitation imposed upon the prices which they would be required to pay under more recent gas purchase contracts and under new contracts to be negotiated by them in the future.

It must also be borne in mind here that it is vital to Phillips' pipeline and distribution company customers, and to

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208 Order issued December 19, 1956 in Docket # G-10 499; order issued March 26, 1958, in Docket # G-11,797.

209 See Initial Decision of Presiding Examiner *In the Matters of El Paso Natural Gas Co., et al.,* Docket Nos. G-12,580, *et al.,* issued February 26, 1959.

210 See Initial Decision of Presiding Examiner *In the Matters of Continental Oil Co., et al.,* Docket Nos. G-13,453, *et al.,* issued February 18, 1959.

the consumer, that Phillips be encouraged to continue a high level of exploration activity. However, if Phillips' rates were fixed on an area-pricing basis, the results might well be such as to defeat this objective. In order to

meet the continually increasing requirements for natural gas reserves, it is important that exploration in the newer and higher-cost areas should be continued and expanded. Such operations might conceivably, in some cases, result in an area cost of service calling for a higher price than pipeline purchasers would be able or willing to pay on an area-rate basis. If Phillips, under such circumstances, were required to absorb the resulting deficiency, it might be compelled to reduce or eliminate its program of exploration and production from such areas—a result which would clearly not be to the advantage of its pipeline or distribution customers, or the consumers.

Similarly, in situations involving exploration and production in a newly-developed area (such as off-shore gas), initial costs would be unusually high and the volume of sales would be relatively low in the early stages. As a result, pipeline purchasers might not be willing to purchase gas from such an area during the initial development period, if the rates therefor were fixed on the basis of an area cost of service. If Phillips, in such a situation, were required to shoulder the resulting deficiency the effect would be to discourage exploration activity in such new areas.

In addition, entirely apart from the problems referred to above, the adoption of an area-pricing approach here would mean that pipeline customers purchasing gas from such newly-developed producing areas in the initial, high-unit-cost years would be required to exclusively shoulder the burden of such high initial costs. Because of the expanding requirements of interveners such as El Paso and Panhandle, and the continuing depletion of reserves in the older and

lower-cost Panhandle area, it is entirely conceivable that such other newly-developed producing areas may become of vital importance to these interveners at some future date. Yet, under their proposed area-pricing approach, if El Paso and Panhandle should later commence to purchase gas from such other areas, at a time when unit costs had dropped to lower and more normal levels, they would then obtain the benefit of reserves which could not have materialized without the high unit cost operations of the earlier years, although they would have incurred no part of the burden of such earlier development period.

Another basic objection made by the Staff and the interveners to the system-wide rate approach is that it disregards wide differences in costs incurred in producing and selling gas as between different areas on the Phillips system. In this connection, the Staff contends that

> "where there is a difference in costs of service as between areas or as between various sales there is a necessity to deviate from uniform rates and the Commission has heretofore recognized this necessity and has effectuated a policy with respect thereto." (initial brief, p. 131)

It is difficult to reconcile this Staff position with the fact, already set forth at length at an earlier point of this decision, that the Staff itself has here constructed a "cost" for all casinghead and condensate gas produced on the Phillips system which is not based upon the actual costs of such gas produced in any given area, but is instead derived by imputing thereto the cost of producing *dry gas* in the Panhandle-Hugoton field.

Furthermore, we know of no basis for the Staff's suggestion, in the statement quoted above, that the Commission "has effectuated a policy" against the use of uniform rates "where there is a difference in costs of service as between

areas". As a matter of fact, the adoption of the system-wide rate approach in this proceeding, reflecting the rate differentials proposed by Phillips to cover its four different delivery condition factors, would mean that each pipeline purchaser receiving the same class of service would pay the same rate. It is concluded that such a result would in no way be inconsistent with Commission policy or with the requirements of the Natural Gas Act.

Another argument made against the system-wide rate approach is that it ignores and needlessly disrupts "the many historical market relationships developed between the Company and its customers over the years". Eastern contends that

> ". . . a well-designed rate schedule should recognize and disturb as little as possible the established relationships which Phillips has with its customers, insofar as they are consistent with sound regulatory principles and objectives." (Eastern initial brief, pp. 55-56)

It is to be noted, however, that Eastern witness Caplan testified that an area-price approach based upon a separate cost of service for each producing area would in fact be subject to the same criticism. (117: 15,748) Furthermore, from a realistic standpoint, this argument loses its persuasiveness when it is recognized that the uniform system-wide rate approved in this decision amounts to only 11.662 cents per Mcf, which is not strikingly higher than the weighted-average field prices in the Panhandle and Permian Basin areas, and which is somewhat lower than the nationwide average price of 12¢ per Mcf paid by interstate pipeline companies for gas purchased directly from independent producers in 1957.[211] In addition, the objection to the sys-

[211] See report issued by the Commission on November 13, 1958, entitled "Direct Sales By Producers Of Natural Gas To Reporting Interstate Natural Gas Pipeline Companies—1957."

tem-wide rate approach as disrupting historical market relationships developed between Phillips and its customers over the years, loses its impact

when it is recognized that, in the absence of Commission regulation of independent producers, many of the Phillips low-priced contracts in the Panhandle and Permian Basin areas would have moved to higher price levels in any event, as escalation clauses became effective.

A final objection made by Eastern to the system-wide rate approach is that

> ". . . it would in reality establish on a company-wide basis the same favored nation concept of a rate making that the honoring of individual favored nation clauses would establish on an area or field basis." (initial brief, pp. 55-56)

Favored nation escalation clauses are regarded as contrary to public policy because of the fact that they automatically bring about producer rate increases without regard to whether a given producer's costs warrant or justify such increases—i.e., such clauses, by their terms, are triggered solely by the fact that a higher price may have been paid under some other contract in the prescribed area. Clearly no such complaint can be made under the instant system-wide rate approach, where rates are established for Phillips on the basis of its system-wide cost of service. This Eastern contention is therefore regarded as unimpressive.

After considering all of the matters outlined above, it is here concluded that the system-wide rate approach represents a satisfactory and appropriate method for the fixing of "just and reasonable" producer rates, for the following reasons:

(1) It is inherently simple to administer.

(2) It would be fair to the producer, in the sense that it permits him to recover his total cost of service in one way or another.

(3) It would eliminate unreasonable preferences currently enjoyed by pipelines which are still purchasing gas under old, abnormally low-priced contracts—preferences which are based not merely upon differences in cost levels, but which reflect other historic reasons.

(4) Although the effect of a system-wide rate would be that pipelines such as Panhandle and El Paso, which are presently enjoying abnormally low prices under certain old, long-term gas supply contracts, would be required to pay a higher price level under such contracts, this would be only a short-term, temporary disadvantage. Furthermore,

any such temporary disadvantage would be counterbalanced by the fact that their necessary purchases of additional gas reserves from more recently developed and higher-cost areas would be made at lower rates than would have resulted under an area-pricing method.

Entirely apart from what has been said above, it makes sense to adopt the systems-wide rate approach in the instant proceeding because:

(1) The Staff's area-pricing method is unacceptable.

(2) The Eastern area-pricing proposal is also regarded as unacceptable.

(3) A conventional area-pricing method, based upon the construction of a separate cost of service for both dry gas and associated gas for each different producing area, is regarded as undesirable. In addition, such a method could not be applied on the basis of the record made in this proceeding, and its adoption would therefore require reopen-

ing the proceeding for a further hearing of indeterminate length. This would not be in the public interest.

It is not only appropriate but essential that the Commission, at this beginning stage of its resolution of the problems involved in producer-rate fixing, should make a serious study of various possible rate-making approaches—in order to finally select a method which will be fair and reasonable to all segments of the natural gas industry and to the consumers, as well as administratively workable. It was in this vein that the Court of Appeals for the Fifth Circuit, in its decision issued February 20, 1959 in *Forest Oil Corporation, et al.*, v. *Federal Power Commission, supra*, mentioned as a possibility for Commission consideration "a uniform price for all of the producers of a single well or a single field". It may be that the Commission, after serious study, may wish to give consideration to the possibility of developing area prices, based upon an industry-wide cost of service for each area, which would be applicable to all producers in such area. However, no such presentation was made in the instant proceeding, and it is clear that the adoption of any such method could not properly be accomplished in a rate proceeding involving a single producer. Furthermore, adequate evaluation of the usefulness and desirability of any such approach would require a major and detailed study, such as has not yet been made in any producer rate case which has reached the point of decision. Among other things, consideration would have to be given to such matters as whether the constitutional prohibition against confiscation might prevent the application to a given producer of an area rate thus derived, which was lower than its own cost of service for such area.

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The adoption of the system-wide rate approach in this proceeding, of course, would not necessarily mean that this basic problem is thus being finally disposed of for all time.

The Commission is here only at the threshold of working out satisfactory solutions to all the key problems involved in the regulation of independent producer rates, and it would be quite unrealistic to expect that all of these difficult and important problems can be solved, for all time, in this one proceeding. The most important contribution which could be made to the industry and the public interest at this time—five years after the date of the Supreme Court's *Phillips* decision—would be to finally close the instant case and speed it on its way to a final decision by the Commission, and later by the Courts. It is also to be hoped that the matters discussed herein will help to bring into sharper focus the real problems to which the Commission will wish to devote further serious attention, not only in its consideration of the instant case but in its consideration of other major producer rate cases now in various stages of hearing before the Commission.

XXIII. RATES PROPOSED BY PHILLIPS WITNESS MAYER

A. *Rate Differentials For Varying Conditions of Delivery*

As previously noted, Phillips witness Mayer considered the effects which varying conditions of delivery should have on prices, and concluded that the following four factors should be reflected for this purpose: (1) point of delivery, (2) pressure, (3) whether dehydrated or undehydrated, and (4) whether sweet or sour. He then established various price differentials, reflecting average conditions, for each of these varying types of delivery. In order to arrive at the proposed rate for each contract, Mayer first calculated, on a basis which will be explained at a later point, a "maximum rate for 1,000-pound, sweet, dehydrated, and gathered gas" —i.e., for gas delivered under the *optimum* conditions with respect to these four factors. In the case of each contract he then deducted from such maximum rate" the particular

delivery condition price differentials applicable to that sale. These price differentials were established as follows:

(1) For wellhead sales at various pressures—1 cent per Mcf at 1,000 pounds; 1.1 cents at 800 pounds; 1.2 cents at 650 pounds; 1.3 cents at 500 pounds; 2 cents at 200 pounds; 2.5 cents at 100 pounds.

(2) For sales of gathered gas at various pressures—0.50 cents per Mcf at 800 pounds; 0.75 cents at 650 pounds; 1 cent at 500 pounds; 2 cents at 200 pounds; 2.75 cents at 100 pounds; 3.75 cents at 40 pounds.

(3) An allowance of 0.25 cents per Mcf was made for dehydration.

(4) For purification or sweetening of sour gas, an allowance of 0.40 cents per Mcf was made for Panhandle sour gas; 0.75 cents per Mcf for all Permian Basin sour gas, except the Crane plant; 1 cent per Mcf for the Crane plant gas in the Permian Basin, because it was unusually sour.

Neither the Staff nor the interveners have challenged the rate differentials referred to above. They appear to be reasonable, and are hereby adopted for the purpose of the instant decision.[212] As noted above, after Mayer determined

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212 El Paso has contended (initial brief, p. 35) that an additional differential should be established for plant residue gas, to reflect the fact that pipeline customers incur various inconveniences and disadvantages with respect to purchases of plant residue gas, due to their lack of control over the volumes to be received at any given time. El Paso notes that substantial volumes of plant residue gas are included in its purchases from Phillips. In the course of interrogation by El Paso counsel on this subject, Phillips witness Mayer stated:

"Well, that w[illegible] be another factor, Mr. Horning, that would fall in the category of so[illegible] of the others that we mentioned; that perhaps in arms' length negoti[illegible]ion might have been given some weight, *but I would certainly know of no way to place any value on it here.* In [illegible]e first place,

his recommended rate differentials for the four delivery condition factors, his next objective was to arrive at a given "maximum rate for 1,000 pound, sweet, dehydrated, and gathered gas". The "maximum rate" selected was one which, when applied to the sales volumes delivered in 1954 under each of the contracts as to which he here proposes specific rates, as adjusted for such rate differentials, would produce a dollar amount which, when added to the revenues collected under existing contract rates for the other contracts, would roughly equal Phillips' claimed jurisdictional cost of service. Using a trial-and-error process, he found that a "maximum rate" of 22.75 cents per Mcf for gas delivered under such *optimum* conditions would produce the desired result, based upon his Exh. 324.

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B. *Categories of Sales For Which Phillips Proposes No Rates*

Mayer abstained from proposing specific rates for three different categories of rate schedules: (1) percentage-type casinghead gas contracts, involving 111 rate schedules (Exh. 288, Sched. I); (2) "*de minimis*" schedules, covering sales averaging less than 400 Mcf per day; and (3) terminated rate schedules. (Exh. 288, Sched. II) He contemplated that Phillips' rate schedules for the first two categories would continue at their present levels.

The Phillips contention that no rates should be fixed in this proceeding for its jurisdictional sales under percentage-type casinghead gas contracts has already been discussed

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it is an unknown condition, if you are talking about future operations." (90: 12,183, lines 7-13, emphasis supplied)

As a matter of fact, El Paso made no attempt, either through evidence or in its briefs, to suggest how a rate differential could be devised which would reasonably reflect this situation. Under these circumstances, it is not possible or appropriate to give further consideration to this matter on the instant record.

in detail and rejected at an earlier point in connection with the issue of "Phillips' Increased Purchased Gas Cost Adjustment". The contention that no rates should here be fixed for *de minimis* contracts is also regarded as unacceptable. In this connection, we agree with the Staff position (initial brief, pp. 142-143) that the requirement set forth in Section 4(a) of the Natural Gas Act that

> "All rates and charges made, demanded or received by any natural-gas company for or in connection with the transportation or sale of natural gas . . . shall be just and reasonable"

applies with equal force to all jurisdictional sales, without regard to the volumes involved. In addition it is, of course, not inconceivable that sales under a given contract which were *de minimis* during the test year might increase to substantial levels during succeeding years.

With reference to terminated contracts, it is important to bear in mind that in determining the rates required to produce revenues equal to our test year cost of service, our calculations must be based upon actual 1954 delivery volumes and delivery conditions. In connection with this determination, the fact that some of the 1954 sales are no longer being made is not relevant, since we are here fixing rates based on a matching of 1954 costs with 1954 sales. The rationale in back of the use of a test period is that, although some of the test period operations may later be discontinued, or new operations may be added, the resulting ratio of operating expenses, plant and volume of sales remains roughly the same. An entirely different proposition, however, will be involved when Phillips in compliance with the instant order makes the required filing of proposed rates for its jurisdictional rate schedules. It is assumed that terminated rate schedules will not be included in such filing, since no purpose would be served by fixing a rate for a

contract under which deliveries are no longer being made.

In view of the considerations outlined above, it is concluded that Phillips should here be directed to calculate the given "maximum rate" for gas delivered under the *optimum* conditions, at such level that its application to the sales volumes delivered in 1954 under each and every

one of the 1954 jurisdictional contracts, as adjusted for the above-mentioned rate differentials, would produce total revenues roughly equal to Phillips' system-wide cost of service as approved in this decision.

C. *Rates For Future Sales*

Phillips contends that the instant decision should fix its jurisdictional rates solely with respect to those rate schedules which were in effect in 1956,[213] and that the rates so prescribed should not be made applicable and binding upon any later and future sales. In this connection, Phillips states:

> "Obviously, rates cannot now be fixed for sales which are not yet in existence. The conditions under which those sales will be made are not now known. The Commission's jurisdiction in this proceeding is limited to those sales being made and cannot by some magic be extended to sales which have not yet begun." (reply brief, pp. 139-140)

Phillips witness Mayer testified that the failure to propose rates for contracts entered into subsequent to 1956 was "because there was no investment in the test year to go with them". He stated:

> "I presume that if the Commission feels compelled to consider those new sales, that they will call a new rate

[213] Reply brief, p. 139, footnote 1; Exh. 357.

hearing, Mr. Lamb. I don't know how we can have a test year of 1954 and consider new contracts, sales from new properties in 1957, which were not included in any kind of cost study." (91 ; 12,276, line 17—12,277, line 5)

This position is found to be without merit. Actually, the Phillips rate base as herein adopted includes substantial amounts of undeveloped acreage, as to which no gas reserves have yet been dedicated to sales contracts. Phillips is thus being allowed (over the objection of some of the interveners) a reasonable return upon undeveloped acreage with respect to which no matching volume of sales or revenues is here reflected. This, of course, represents a significant advantage for Phillips.

In addition, however, it is important to bear in mind here that the use in this proceeding of a 1954 test year, with the adjustments

herein approved on the basis of "known changes", is based upon the determination made herein that the relationship of operating expenses, plant and volume of sales for the year 1954, as thus adjusted, is representative of the relationship between these three factors which pertains for the ensuing and future years. If this assumption is sound, it is reasonable to expect that even though some additional facilities might be required in connection with new sales made after 1956, and even though the total operating expenses, plant and volume of sales for such ensuing years might not be identical with such figures for the year 1954, nevertheless the ratio between the three factors would still remain roughly the same. Under such circumstances, if the rates herein approved for Phillips' jurisdictional sales are made applicable to contracts executed in the ensuing years, the overall result should still be the preservation of roughly

the same relationship between operating expenses, plant and revenues.[214] If, however, as a result of significant changes in any one or more of these three basic factors in the future, it should develop that the test year relationship of operating expenses, plant and volume of sales was no longer representative, Phillips would, of course, then have the opportunity to file a new rate proceeding for the purpose of determining a new cost of service and a new level of "just and reasonable" rates based thereon.

It actually does not appear that this situation involves any problems more difficult than those which are disposed of routinely in pipeline rate proceedings. Under the Commission's long-established procedures, the rates approved in a pipeline rate case become the legally effective rates of the pipeline for all future jurisdictional sales, until such rates may be changed in a subsequent rate proceeding.

If, instead, we were here to adopt the Phillips position that the rates herein approved should be made applicable only to contracts which were in existence in 1956, the results would be clearly contrary to the public interest. It would mean that, although it is here concluded that a system-wide rate of 11.662 cents per Mcf represents the "just and reasonable" rate for all of Phillips' jurisdictional sales, nevertheless sales would continue to be made by Phillips under contracts executed in 1957 and 1958 at contract prices which in many cases are substantially

higher than the rate level herein approved. In addition, it would mean that sales under new contracts hereafter executed by Phillips could be made without reference to the

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[214] It may also be noted, in this same connection, that although such new facilities as might possibly be required in connection with new contracts are not reflected in our instant test year rate base, this is counterbalanced by the fact that the corresponding additional volumes of sales and revenues are also not reflected herein.

"just and reasonable" rate level approved in this decision. The only protection to the consumer, under such circumstances, would lie in the possibility of Section 5(a) proceedings instituted by the Commission. Any such remedy, however, would place the consumers at a serious disadvantage, since any reduction in rates which may be ordered by the Commission in a Sec. 5(a) proceeding can take effect only from and after the date of such order—and experience shows that there is an extremely long time-lag between the date of commencement of such a proceeding and the ultimate issuance of the Commission's final decision.[215]

It is concluded that such a result would be inconsistent with the primary aim of the Natural Gas Act to protect the consumers from exploitation, and that it is not required or justified by anything shown in this proceeding. Accordingly, the rates herein approved for Phillips' jurisdictional sales will be made applicable to all jurisdictional sales, whether under rate schedules presently in effect or new sales to be made hereafter—unless and until such rates may be changed by the Commission in a subsequent rate proceeding.

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XXIV. THE SPECIAL ISSUE RAISED WITH RESPECT TO EL PASO, PANHANDLE AND MICHIGAN-WISCONSIN, BY COMMISSION ORDER ISSUED APRIL 26, 1957.

This problem arose when El Paso on March 12, 1957 filed in Docket No. G-11217 (one of the Phillips Sec. 4(e) dockets consolidated herein) a "Motion by El Paso Natural Gas Company to Djsmiss Docket No. G-11217 and Request by

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[215] Commission statistics show that Section 5(a) proceedings in pipeline rate cases have averaged approximately 36 months in duration, with a range of between 73 months and 10 months. (See p. 97 of brief filed with the United States Supreme Court on behalf of the Federal Power Commission in the *Memphis* case, *supra*, August 1958)

El Paso Natural Gas Company for an early Limited Hearing on the Issues Here Presented". El Paso contended in this Motion that Phillips' proposed rate increases in Docket No. G-11217 are void and of no legal effect because they are based upon spiral escalation provisions which are contrary to public policy; that the operation of these spiral escalation provisions had been suspended, and that they were inoperative because the conditions precedent to their triggering had not been fulfilled; that under these circumstances Phillips' rate increase filings in Docket No. G-11217 were illegal and unauthorized under the rate schedules and constituted prohibited unilateral rate filings under the holding of the Supreme Court in the *Mobile* case, *supra;* that such rate filings should accordingly be rejected and the proceeding in Docket No. G-11217 should be terminated.

By order issued April 26, 1957, in this consolidated proceeding, the Commission permitted Phillips' proposed Sec. 4(e) rates in Docket No. G-11217 to go into effect subject to refund; denied El Paso's request for a limited hearing with respect to the above issue; and noted that in addition to this issue as raised by El Paso in Docket No. G-11217, a similar issue was also involved in Dockets Nos. G-10793 and G-10883 which are also consolidated with the instant proceeding. Docket No. G-10793 is a Phillips Sec. 4(e) rate filing covering a sale to Michigan-Wisconsin, and Docket No. G-10883 involves a Phillips sale to Panhandle. The Commission Order noted that the Phillips rate schedules involved in these two latter rate filings contain spiral escalation provisions similar to those complained of by El Paso as being "contrary to public policy", and stated:

> ". . . it is deemed appropriate and in the public interest that the legality of Phillips' rate filings in these three dockets be considered in the consolidated proceedings."

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Accordingly, in paragraph (1) of its findings in the said Order, the Commission directed that the instant consolidated hearing should include among other things:

> ". . . the issues involved in Docket Nos. G-10793, G-10883, and G-11217 whether (a) Phillips' increased rate filings in the proceedings in Docket No. G-11217 for sales of natural gas to El Paso constitute unilateral filings within the meaning of the *Mobile* case. . .;

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> and (b) the spiral escalation provisions contained in Phillips' FPC Gas Rate Schedules Nos. 7, 9, 32, 33, 64 and 243 applicable to sales of natural gas to El Paso and the similar escalation provisions in Phillips' FPC Gas Rate Schedules Nos. 4 and 5 applicable to sales of natural gas to Michigan-Wisconsin and to Panhandle, respectively, are so ambiguous in language and so inflationary in effect as to contravene the public interest and conflict with the regulatory powers of the Commission, or are otherwise unlawful."

As already held in an early part of this decision, under the principle laid down by the Supreme Court in its *Mobile* decision, *supra*, the Phillips rates in existing contracts cannot be changed unilaterally. Accordingly, the Sec. 4(e) rate increase procedure is only available for the rate schedules referred to above to the extent that the terms of the contracts themselves permit such price changes. However, it has also been concluded that the controlling facts in this proceeding do satisfy the Sec. 5(a) standards as laid down by the Supreme Court in the *Mobile* and *Sierra Pacific* cases, *supra*. Accordingly, from and after the date when the rates herein fixed may be finally approved by the Commission (following steps which may be taken by Phillips pursuant to the instant Order), Phillips *would* be entitled

to collect such rates *prospectively*. The Sec. 4(e) issues raised in the El Paso Motion would be entirely irrelevant in this connection, since Phillips' rates are here being fixed solely on the basis of its system-wide cost of service as here determined, and no weight whatsoever has been given in this connection to the spiral escalation provisions of the Phillips-El Paso contracts, which are attacked in the El Paso Motion.

However, this does not dispose of or resolve the question of Phillips' right to its proposed Docket No. G-11217 rates from March 11, 1957, when it commenced collecting such rates pursuant to refund undertaking, to the date when the cost of service rate levels herein approved will become effective prospectively under our Sec. 5(a) determination. That particular question, the resolution of which will determine whether El Paso is entitled to any refund under Docket No. G-11217 for the past refund period, must be resolved under Sec. 4(e). The solution to this particular question will depend upon whether El Paso may be regarded as having consented to such Sec. 4(e) rate increases, by virtue of the escalation provisions contained in the Phillips-El Paso contracts. If this question is answered affirmatively, the Phillips Sec. 4(e) rate filing in Docket No. G-11217 would not constitute a unilateral rate increase, as barred by the *Mobile* doctrine. It would then follow that, since the system-wide unit cost of service herein approved for Phillips exceeds the level of rates proposed by Phillips in its Docket No. G-11217 rate filing, no refund to El Paso would be required in this connection.

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We turn now to a discussion of the spiral escalation provisions involved in these Phillips-El Paso contracts, and the precise contentions made by El Paso in that connection. Throughout this entire discussion it is important to bear in mind that these spiral escalation provisions are referred

to here for the sole purpose of determining whether they provide the basis for a finding of *El Paso consent* to the Phillips Sec. 4(e) rate filing in Docket No. G-11217, such as to free that rate filing from the taint of a unilateral rate increase barred by the *Mobile* doctrine.

El Paso's first contention is that the spiral escalation provisions here involved were contrary to the public interest and therefore void; that accordingly they cannot be regarded as an effective El Paso consent to Phillips' Docket No. G-11217 rate filing. In this connection, El Paso stresses the Commission holding in Op. No. 275, *In the Matter of Michigan-Wisconsin Pipe Line Company*, to the effect that such spiral escalation provisions are

> "inconsistent with the standards of the Natural Gas Act, and contrary to the public interest as a matter of law." (p. 39, Mimeo Opinion)

El Paso accordingly contends that the spiral escalation provisions are a nullity, and that the Phillips-El Paso contracts must be construed as though such provisions had never been incorporated therein; that Phillips' rate filings in Docket No. G-11217 were therefore illegal and unauthorized because they were not made pursuant to a *valid* right reserved in the contracts to apply for increases under Sec. 4(e); that they accordingly constitute prohibited unilateral rate filings within the doctrine of the Supreme Court's *Mobile* decision.

This argument is regarded as without merit. The import of the Supreme Court's *Mobile decision*, as made clear in its later *Memphis* decision, *supra*, was that where the pipeline seller's contract contained no provision for changing the agreed rate during the term of the contract, it had no right to unilaterally abrogate such an unqualified contract obli-

gation and to increase its price to the purchaser at will, subject to the Sec. 4(e) procedure.[217] However,

with respect to the Phillips-El Paso contracts here involved we have an entirely different situation. Here the two parties admittedly had agreed in their original basic contract that the initial contract rate might be changed from time to time during the term of the contract under the escalation mechanism. Furthermore, these agreements were executed prior to the time when this Commission embarked upon its regulation of independent producers, under the Supreme Court's *Phillips* decision of June 7, 1954, and prior to the time when the Commission expressed its position that such spiral escalation provisions were contrary to the public interest. It should also be noted that the El Paso theory that the escalation provisions should be treated as a nullity for the purpose of this particular problem is squarely contradicted by the holding of the Court of Appeals for the Tenth Circuit in *Phillips Petroleum Company* v. *F.P.C.*, 227 F 2d 470 (1955), and *Kerr-McGee Oil Industries, Inc.* v. *F.P.C.*, decided October 24, 1958. In both of these cases the Court determined the legally effective rate of the producer, as of June 7, 1954, by giving effect to similar spiral escalation provisions contained in contracts between the producer and its purchaser.

It would, of course, be clearly contrary to public safety to allow rates to be increased automatically under spiral escalation provisions without regard to whether the producer's costs warrant or justify such increases. However, the same objection is not applicable to merely treating the escalation provisions as representing customer consent which renders the Sec. 4(e) procedure available here to Phillips—so long as the determination of just and reasonable rates under

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217 *United Gas Pipe Line Company* v. *Memphis Light, Gas and Water Division, et al.* (December 8, 1958), page 6 of slip-sheet opinion.

Sec. 4(e) is then based exclusively upon Phillips' cost of service.

In addition to the argument discussed above, El Paso further contends that even if the mentioned escalation provisions are not to be regarded as a nullity, they failed to become operative for reasons which will now be set forth. The Phillips-El Paso contracts, which are on file as Phillips' Rate Schedules Nos. 7, 9, 32, 33, 64 and 243, contain an escalation provision providing that when the commodity index shall have increased more than a prescribed number of points and a general increase in El Paso's rates shall have been put into effect, then Phillips' rates shall be increased in proportion to such increase in El Paso's rates. On January 1, 1953, Phillips and El Paso executed an amendatory contract, amending each of the contracts identified above. By Article VIII of this Amendatory Agreement, a new escalation provision was adopted for each and every one of these contracts, providing:

> "no adjustment shall be made unless and until (1) the Annual Index shall be more than 19.06 points above the level 66.7 and El Paso shall have had an increase in resale rates. . . . When revised rates shall become effective during any adjustment period, the price for gas delivered hereunder shall be adjusted to a price which bears the same ratio to the price provided in Sec. 1 of this article which the revised resale rates bear to the resale rates in effect immediately prior to revision."

In addition, Article X of the Amendatory Agreement provided that these escalation provisions should be inoperative until El Paso by final decision of the Federal Power Commission should receive in full certain rate increases in the amount of $12,142,803 which had been applied for and which

were the subject of proceedings then pending before the Commission in Docket No. G-2018; that the escalation provision should then again become effective and thereafter an adjustment in Phillips' rates would occur whenever revised rates for El Paso should become effective.

It is not disputed that the Commission on July 20, 1956 did issue a final order in Docket No. G-2018 approving a settlement between El Paso and its customers, under the terms of which El Paso, effective January 1, 1954, received the full rate increases sought in that proceeding. In its "Answer To Petition Filed For Shortening of Suspension Period . . .", filed with the Commission on January 14, 1957 in Docket No. G-11217, El Paso stated that it

> ". . . did receive the full rate increases sought in that proceeding effective as of January 1, 1954."

However, El Paso contends that because the full rate increase which it received in Docket No. G-2018 was made effective only for the period commencing January 1, 1954, and did not cover the period from January 1 to December 31, 1953, it has not in fact received the "full" increase sought in that docket; that accordingly the terms of Article X of the Amendatory Agreement of January 1, 1953 were not satisfied, and the escalation provisions in the mentioned Phillips-El Paso contracts are therefore still not operative.

This theory cannot be regarded as having any serious merit. It was the clear purpose of the suspension provision contained in Article X of the Amendatory Agreement of January 1, 1953 to render the escalation mechanism temporarily inoperative until El Paso received Commission approval for the $12,142,803 rate increase proposed by it in Docket No. G-2018. However, it is not reasonable to suggest

that even though the El Paso rate increase was approved for this entire amount, the mere failure of the Commission

Order to make the full increase effective from the very beginning of the refund period would be sufficient to render the escalation mechanism permanently inoperative. It is, therefore, concluded that the conditions laid down by Article X of the Amendatory Agreement of January 1, 1953 were satisfied by the Commission's final order issued July 20, 1956 in Docket No. G-2018, and that, accordingly, the escalation provision of the original contract thereupon again became effective.

Following the termination of the proceedings in Docket No. G-2018, El Paso filed a further proposed rate increase under Sec. 4(e) which became the subject of Docket No. G-4769. These revised rates were allowed by the Commission to become effective on April 15, 1955, pursuant to refund order. It is this second El Paso increase which was treated by Phillips as triggering the escalation provision, and which accordingly became the basis for Phillips' own rate increase proposal in Docket No. G-11217, filed September 10, 1956. In Docket No. G-4769 an Initial Decision issued by the Presiding Examiner is presently pending before the Commission on appeal, but no final decision has yet been issued.

Entirely apart from its first argument outlined above, El Paso contends that the escalation provision contained in the Phillips-El Paso contracts can be triggered only by a *final* decision increasing El Paso rates; that the fact that El Paso is presently collecting the Docket No. G-4769 rate increases subject to refund is not in itself sufficient to make the escalation provision effective; that until the amount of the increase in resale rates, if any, to which El Paso will become entitled by final decision of the Commission in Docket No. G-4769 is determined, any application by Phillips for a Sec. 4(e) rate increase, based upon such escalation provision, is premature.

In answer to this contention, Phillips stresses the fact that, in contrast with the escalation suspension provision

contained in Article X of the Amendatory Agreement, which speaks in terms of a "final decision" to be entered by the Commission with respect to Docket No. G-2018, the basic escalation provision in Article VIII of the Amendatory Agreement requires only that revised rates for El Paso "shall become effective" in order to trigger the escalation clause. Phillips therefore contends that even though the El Paso rate increases in Docket No. G-4769 are still being collected subject to possible refund, they are nevertheless "effective" within the meaning of the escalation clause referred to above. This argument goes too far. The basic escalation provision provides that

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when the stated conditions are satisfied, the existing Phillips rate should be escalated in the same ratio as the rate increase received by El Paso. The adoption of the Phillips rationale would require an assumption that the escalation provision permitted Phillips to increase its price to El Paso in the same ratio as the increase *proposed* by the latter in its G-4769 filing, without regard to whether the Commission might ultimately disapprove all or a part of such rate increase proposal. Such an interpretation, however, is regarded as unreasonable.

It is concluded here that when El Paso commenced collecting its proposed G-4769 rates subject to refund, the escalation provision in the Phillips-El Paso contracts became operative *on a tentative basis*, in the sense that the precise amount of the increase triggered by such escalation provision was contingent upon the ultimate resale rate to be finally established by the Commission for El Paso in that docket. When the Commission ultimately determines the El Paso rates under Docket No. G-4769, the precise amount of the Phillips increase triggered by such escalation provision will then be established retroactively by relation back to the beginning of the refund period in Docket No. G-

11217.[218] If the amount of the Phillips escalation increase, determined on that basis, should be less than the amount of Phillips' proposed Section 4(e) rate increase to El Paso in Docket No. G-11217, it would follow that any such excess portion included in the G-11217 rate filing would constitute a *unilateral* increase barred under the *Mobile* doctrine. Any such excess portion would then be recoverable by Phillips, if at all, only *prospectively* on the basis of the Sec. 5(a) finding made in this decision. In addition, any such excess portion would have to be refunded by Phillips to El Paso from the beginning of the refund period in Docket No. G-11217 to the effective date when such excess portion might become legally collectible pursuant to the Sec. 5(a) determination made herein. The terms of the instant Order will accordingly set forth the steps required to accomplish this objective.

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The conclusions expressed above with respect to the effect of the spiral escalation provisions in the Phillips-El Paso contracts are equally applicable to the similar escalation provisions contained in the Phillips-Michigan Wisconsin contracts which are the subject of Docket No. G-10793, and the Phillips-Panhandle contracts which are the subject of Docket No. G-10883. With respect to Docket No. G-10793, involving the sales to Michigan-Wisconsin, it is sufficient to note here that Michigan-Wisconsin makes no contention that the escalation provisions in its contract with Phillips have not yet become operative under their terms. With respect to this general question, Michigan Wisconsin states (p. 6 of initial brief):

> "Michigan Wisconsin has not disputed the reasonableness of price increases which have been required by

[218] See *Phillips Petroleum Co.* v. *F.P.C.*, 227 F. 2d 470 (CCA 10, 1955); and *Kerr-McGee Oil Industries, Inc.* v. *F.P.C.*, (CCA 10, October 24, 1958).

the contracts, and does not propose in this brief to discuss the evidence with respect to the contract increases."

In the case of Docket No .G-10883, involving Phillips' sales to Panhandle, the situation is similar to that already discussed above with respect to the Phillips-El Paso contracts. The Phillips proposed rate increase to Panhandle in this docket is based upon a similar spiral escalation provision in Phillips' Rate Schedule No. 5. Phillips contends that this escalation provision was triggered when Panhandle on January 1, 1955 commenced collecting, subject to refund, higher rates filed by it in its Docket No. G-2506. An initial decision of the Presiding Examiner has been issued in that case on February 10, 1959, and it is presently pending before the Commission on appeal. Under these circumstances, Panhandle contends that Docket No. G-10883 cannot be finally disposed of until the Panhandle resale rates have been ultimately established by final order of the Commission in Docket No. G-2506. Panhandle accordingly contends:

". . . any order issued in the instant proceeding must condition the relief granted Phillips in Docket No. G-10883 upon Phillips' agreement to refund the proportionate amount of the increase per Mcf collected since September 1, 1956, in the event Panhandle is required to make refunds in that proceeding. And, of course, any order in Docket No. G-10883 must be conditioned upon Phillips' filing lower rates as to the future, effective upon the date of final order in Docket No. G-2506, in the event any part of Panhandle's rates are disallowed in that proceeding." (initial brief, p. 9)

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Following the same analysis set forth above with respect to the Phillips-El Paso contracts, it is concluded here that

when Panhandle commenced collecting its proposed G-2506 rates subject to refund, the escalation provision in the Phillips-Panhandle contract became operative *on a tentative basis*, in the sense that the precise amount of the increase triggered by such escalation provision was contingent upon the ultimate resale rate to be finally established by the Commission for Panhandle in that docket. When the Commission ultimately determines the Panhandle rates under Docket No. G-2506, the precise amount of the Phillips increase triggered by such escalation provision will then be established retroactively by relation back to the beginning of the refund period in Docket No. G-10883. The terms of the instant Order will accordingly set forth the steps required to implement these conclusions. It should also be noted that, just as in the case of the Phillips-El Paso contracts, Phillips' rates to Panhandle for the future may be fixed *prospectively* on the basis of the cost of service herein determined for Phillips, pursuant to the Sec. 5(a) procedure already outlined above.

Similarly, it is to be observed that we are here treating the escalation provisions in the Phillips-Michigan Wisconsin contracts and the Phillips-Panhandle contracts solely as the basis for a finding that there was customer consent such as to make the Sec. 4(e) procedure available whether the rates proposed by Phillips in Dockets Nos. G-10793 and G-10883 constitute "just and reasonable" rates, we have been governed exclusively by the cost of service determination made in this decision, and no weight or value whatsoever has been given to the escalation provisions in the Phillips contracts with Michigan-Wisconsin or Panhandle in connection with this determination. Under these circumstances, it is concluded that no further comment is here required with regard to the issues outlined in the Commission's Order of April 26, 1957, with respect to the escalation provisions involved in Dockets Nos. G-11217, G-10793 or G-10883.

XXV. THE OBJECTIVES TO BE ACCOMPLISHED BY THE INSTANT ORDER AND THE STEPS REQUIRED TO IMPLEMENT SUCH OBJECTIVES

Because of the fact that we are here approving a totally different cost of service than that presented by Phillips in this proceeding, it is necessary that rates should now be designed, based upon the approved cost of service, for each of the Phillips jurisdictional rate schedules currently in effect. This should be accomplished by Phillips calculating the given "maximum rate" for gas delivered under the *optimum* conditions, in the manner described above, and by applying the approved rate differentials to such "maximum rate".

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It will then be necessary for Phillips to file with the Commission a list of such *calculated rates*, together with certain necessary data required to explain how such rates were constructed—and the *calculated rates* as thus filed will, of course, be subject to Commission approval.

Section 5(a) of the Natural Gas Act provides:

> "the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural gas company . . ."

However, the Supreme Court in the *Mobile* decision, *supra*, made it clear that

> ". . . if the Commission, after hearing, determines the contract rate to be so low as to conflict with the public interest, it may under Sec. 5(a) *authorize* the natural

gas company to file a schedule increasing the rate." (350 U.S., at page 345, emphasis supplied)[219]

Accordingly, with respect to any existing Phillips rates which are lower than the *calculated rates* which may be filed by Phillips pursuant to the instant Order and which may thereafter be approved by the Commission pursuant to the Sec. 5(a) determination made in this decision, certain additional steps will be required before such higher *calculated rates* can become legally effective, as follows: (1) An Order by the Commission authorizing Phillips to thereafter file rate schedules increasing such existing rates to the level of the approved *calculated rates;* and (2) a subsequent new filing by Phillips under Sec. 4(e) pursuant to such Commission authorization.

Because of the fact that the various Phillips jurisdictional sales involve a number of different types of situations, each requiring somewhat different treatment, it will be helpful at this point to summarize the general objectives which the instant Order is designed to accomplish. It is contemplated that this Order will accomplish the following results:

(1) In the case of Phillips' proposed Sec. 4(e) rates which are lower than the *calculated rates* as subsequently to be approved by the Commission, the proposed Sec. 4(e) rate would constitute the legally effective rate from the beginning of the refund period, and until Phillips, pursuant to the terms of the instant Order, should take the steps required to make the higher *calculated rate* effective prospectively.

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219 To the same effect, see *Interstate Power Company* v. *F.P.C.*, 236 F. 2d 372 (CCA 8, 1956), at p. 378.

(2) However, with respect to Dockets Nos. G-11217 and G-10883, the interim Sec. 4(e) rates applicable to Phillips' sales to El Paso and Panhandle would ultimately be fixed retroactively by relation back to the beginning of the refund period, on the basis of the resale rates finally approved by the Commission for El Paso in Docket No. G-4769 and for Panhandle in Docket No. G-2506.

(3) In the case of Phillips' proposed Sec. 4(e) rates which are higher than the above-mentioned *calculated rates* as approved by the Commission, such Sec. 4(e) rates will be reduced to the level of the *calculated rates*, effective by relation back to the beginning of the refund period, and Phillips would be required to make appropriate refunds on that basis.

(4) In the case of those Phillips jurisdictional rates which are not the subject of a Sec. 4(e) rate filing, and which are higher than the above-mentioned *calculated rates* as approved by the Commission, such rates would be reduced to the level of the mentioned *calculated rates* from and after the date when the said *calculated rates* are approved by the Commission.

(5) In the case of Phillips' jurisdictional rates which are not the subject of a Sec. 4(e) rate filing, and which are lower than the *calculated rates* as approved by the Commission, the filed contract rate will continue to be the legally effective rate until Phillips, pursuant to the terms of the instant Order, may take the steps required to make the higher *calculated rate* effective prospectively.

XXVI—THE EFFECT OF THIS DECISION, IN SUMMARY

As already noted above, the total jurisdictional cost of service herein approved for Phillips amounts to $57,280,218, representing an average unit cost of 11.662 cents per Mcf.

It is also of interest to note again that the Phillips average unit cost as thus determined is reasonably in line with the nation-wide average price of 12 cents per

Mcf paid by interstate pipeline companies for gas purchased directly from independent producers in 1957.[220] This would seem to raise serious doubt as to the validity of the charge frequently made during the past few years that any attempt to apply the cost-of-service or rate-base method to the fixing of producer rates would necessarily produce impossible and ridiculous results.

The $57,280,218 total jurisdictional cost of service and the 11.662 cent per Mcf average unit cost here approved may be compared with the claimed cost of service presented by Phillips in this proceeding in the amount of $92,309,438, representing a claimed average unit cost of 18.793 cents per Mcf, with proposed rates running from 22.75 cents to 16.50 cents depending upon delivery conditions.

The effect of the instant decision, including both the Sec. 4(e) increases herein approved and the additional rate changes which Phillips may obtain pursuant to the Sec. 5(a) procedure outlined herein, would be to provide Phillips with an aggregate rate increase totaling $14 million annually, over and above its jurisdictional revenues prior to the filing of the Sec. 4(e) rate increases involved in this consolidated proceeding. This compares with a $49 million annual increase sought by Phillips. The aggregate increase of $14 million annually, resulting from this decision, would be roughly $8¾ million higher than the $5¼ million increase reflected in Phillips' consolidated Sec. 4(e) dockets—which the interveners have here expressed their willingness to accept.

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220 See report issued by the Commission on November 13, 1958, entitled "Direct Sales By Producers Of Natural Gas to Reporting Interstate Natural Gas Pipeline Companies—1957."

In spite of the large number of seriously controverted issues presented in this proceeding, which have made necessary the lengthy analysis set forth herein, it is interesting to note that the difference of some $35 million between the total cost of service herein approved and that claimed by Phillips results primarily from the difference in treatment of four major issues, as follows:

(1) The income tax component, as to which Phillips' claimed phantom tax allowance is here rejected.

(2) The allowance of a 9.25 percent rate of return, instead of the 12 percent rate proposed by Phillips.

(3) The allocation of exploration costs, as to which the RAR method is here adopted, with a resultant 30.5 percent allocation to gas, instead of Phillips' combined net investment-Btu method which assigns somewhat over 61.8 percent of exploration costs to gas.

(4) The treatment of Phillips' claimed increased purchased gas cost adjustment. The instant decision rejects Phillips' proposed adjustment based upon increased purchased gas costs which it claims will be incurred as a result of the rate increases approved herein. In addition, the royalty and gathering tax adjustments as herein approved are calculated on the basis of a substantially lower total cost of service than that used in the Phillips calculation.

FINDINGS AND CONCLUSIONS

Upon consideration of the entire record in this proceeding, the evidence adduced and the briefs filed, the Presiding Examiner finds and concludes, in addition to the findings and conclusions hereinbefore stated, that

(31651)

(1) The total system-wide jurisdictional cost of service determined for Phillips in this proceeding is $57,280,218, as set forth in Appendix Table 12 hereof.

(2) It is desirable and appropriate that rates should be designed for all of Phillips' jurisdictional sales based upon such system-wide cost of service, and reflecting the delivery condition rate differentials as approved herein, pursuant to the procedure set forth in the order below.

ORDER

WHEREFORE, IT IS ORDERED, subject to review by the Commission on appeal, or upon its own motion as provided in the Commission's Rules of Practice and Procedure, that:

(A) Based on the system-wide cost of service herein approved, as set forth in Appendix Table 12 hereof, Phillips shall calculate the "maximum rate for 1,000-pound, sweet, dehydrated, and gathered gas," at such level that its application to the sales volumes delivered in 1954 under each and every one of the 1954 jurisdictional contracts, as adjusted for the approved delivery condition rate differentials, will produce total revenues roughly equal to such system-wide cost of service.

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(B) Within 60 days from the date of issuance of this Order, Phillips shall file with the Commission a statement of such "maximum rate," including a clear and detailed explanation as to the manner in which it was calculated, together with a list of *calculated rates* for all of its jurisdictional rate schedules then in effect. The following information shall be set forth with respect to each such rate schedule: (1) the F.P.C. Rate Schedule number; (2) the name of the purchaser; (3) the delivery point; (4) delivery

pressure, in psig; (5) whether dehydrated or undehydrated; (6) whether sweet or sour; (7) the *calculated rate*, based upon the application of the above-mentioned rate differentials to such "maximum rate."

(C) Upon approval of such *calculated rates* by the Commission, in the case of all rate schedules other than those covered by the proviso below, the *calculated rates* shall immediately become the legally *effective rates for such contracts*, to be observed and in force unless and until changed by subsequent order of the Commission; *provided, however*, that with respect to any such *calculated rates* for sales which are the subject of pending Phillips Sec. 4(e) rate filings, and which are in excess of the Phillips proposed Sec. 4(e) rate, Phillips, after such *calculated rates* are approved by the Commission, will be authorized to file with the Commission new rate schedules increasing such filed Sec. 4(e) rates to the level of the approved *calculated rates*. The same procedure may be followed with respect to any such *calculated rates* affecting a Phillips contract which is not the subject of a pending Phillips Sec. 4(e) rate filing, and where the *calculated rate* exceeds the rate permitted under the terms of the contract. However, in all cases covered by this proviso, until the filing of such new rate schedules by Phillips pursuant to this provision, its legally effective rates for such contracts shall consist of the above-mentioned Sec. 4(e) filed rate, or of the contract rate as the case may be—except that with respect to Dockets Nos. G-11217 and G-10883 herein, the interim Sec. 4(e) rate shall be as determined under the provisions of paragraphs (G) and (H), *infra*.

(D) All jurisdictional contracts hereafter executed by Phillips as seller shall be at rates not exceeding the above-mentioned "maximum rate," adjusted by such delivery con-

dition rate differentials, as approved by the Commission, until further order of the Commission.

(E) With respect to all those Phillips Sec. 4(e) rate filings which are consolidated with the instant proceeding, and under which Phillips, subject to a refund undertaking, has been collecting rates higher than such *calculated rates* as approved by the Commission, Phillips will be required to make appropriate refunds, as determined and directed in a subsequent order to be issued by the Commission.

(F) With respect to all those Phillips Sec. 4(e) rate filings which are consolidated with the instant proceeding, and under which Phillips, subject to refund undertaking, has been collecting rates not in excess of the *calculated rates* as approved by the Commission, such Sec. 4(e) proceedings will thereafter be ordered terminated and Phillips will thereupon be relieved of any obligation to make refunds thereunder—with the exception of the Phillips Sec. 4(e) rate filings in Dockets Nos. G-11217 and G-10883, as to which special provision is set forth in paragraphs (G) and (H) below.

(G) Upon the issuance of a final Commission decision in El Paso's pending Sec. 4(e) rate proceeding in Docket No. G-4769, Phillips shall file with the Commission a Motion Requesting Termination of its Sec. 4(e) proceeding in Docket No. G-11217. A determination will thereupon be made of the appropriate Phillips Sec. 4(e) rate in Docket No. G-11217, based upon the rate increase ultimately approved for El Paso in Docket No. G-4769, but in no event to exceed the above-mentioned *calculated rate* as approved by the Commission for such Phillips-El Paso sale. The Phillips Sec. 4(e) proceeding in Docket No. G-11217 will then be ordered terminated, subject to such appropriate refund order, if any, as may be warranted in the event that El

Paso's proposed Sec. 4(e) rate increase in Docket No. G-4769 may not have been approved *in toto.*

(H) Upon the issuance of a final Commission decision in Panhandle's pending Sec. 4(e) rate proceeding in Docket No. G-2506, Phillips shall file with the Commission a Motion Requesting Termination of its Sec. 4(e) proceeding in Docket No. G-10883. A determination will thereupon be made of the appropriate Phillips Sec. 4(e) rate in Docket No. G-10883, based upon the rate increase ultimately approved

for Panhandle in Docket No. G-2506, but in no event to exceed the above-mentioned *calculated rate* as approved by the Commission for such Phillips-Panhandle sale. The Phillips Sec. 4(e) proceeding in Docket No. G-10883 will then be ordered terminated, subject to such appropriate refund order, if any, as may be warranted in the event that Panhandle's proposed Sec. 4(e) rate increase in Docket No. G-2506 may not have been approved *in toto.*

JOSEPH ZWERDLING
Presiding Examiner

31766

PHILLIPS PETROLEUM COMPANY

BARTLESVILLE, OKLAHOMA

May 28, 1959

Mr. J. H. Gutride, Secretary
Federal Power Commission
441 'G' Street, N. W.
Washington 25, D. C.

Re: In the Matter of Phillips Petroleum Company, Docket No. G-1148, et al.

Dear Sir:

By Motion served April 16, 1959, Northern Natural Gas Company and Permian Basin Pipeline Company requested that the Commission enter an order in this proceeding requiring that Phillips Petroleum Company, without prejudice to Phillips' rights, make known to Northern and Permian the "calculated rates" which Phillips would be required to file under the Examiner's decision in this proceeding, for sales of gas to Northern and Permian. Subsequently, Southern California Gas Company, Southern Counties Gas Company, Pacific Gas and Electric Company and San Diego Gas and Electric Company filed motions seeking similar information and, in addition, a comparison of such "calculated rates" with the actual rates in effect on April 1, 1959, together with the 1958 volumes applicable thereto. The motions request that such information be furnished not later than May 15, 1959.

All of these motions together would, in effect, require that Phillips now comply fully with the Examiner's decision in this proceeding, that it furnish additional information not required by the Examiner, and that all of this be done in little more than half the time permitted by the Ex-

aminer's decision. We think it is apparent that this is not a reasonable request. The information required to formulate the "calculated rates" in the exactness required by paragraphs (A) and (B) is not readily available even to Phillips. Paragraphs (A) and (B) differ substantially from the rate recommendations made by Phillips during the hearing. Among other things, these paragraphs would require that "calculated rates" be

filed with respect to contracts considered *de minimis* by Phillips and for which no change in contract rate was proposed. Since many of these sales are from individual wells in which Phillips is only a small interest owner and the non-operator, the information with respect to delivery conditions (necessary for the application of the required rate differentials), is not maintained in Phillips' files and would have to be obtained from the various operators.

We recognize, however, that these requests were made in an effort to appraise the effects of the Examiner's decision and that information which may be most readily available to Phillips would be of material assistance to the other parties to the proceeding. We believe that approximate rates applied to Phillips' major sales only will provide all of the information which these parties may desire or find useful and at the same time will avoid placing undue burden upon Phillips.

We have calculated that the "maximum rate" referred to in paragraph (A) of the Examiner's decision would, under all of the conditions of the Examiner's decision, be approximately 15¢ per Mcf at 14.65 psia. In determining this approximate "maximum rate" we have not attempted to establish rates for all of Phillips' sales, as the Examiner's decision would require. We have not determined the "calculated rate" for any sale for which no rate was recom-

mended by Phillips in Exhibits 324 and 357, but in determining the "calculated rates" for other sales we have taken into acount the revenues at contract rates for sales under percentage-type casinghead gas contracts and sales which were considered by Phillips as *de minimis*. As previously indicated, determination of "calculated rates" for casinghead gas and *de minimis* sales would substantially increase the time and effort required to furnish this information. The total volume of all such sales is so small that it does not appear that the income from such sales would have any substantial effect upon the "maximum rate".

We are attaching hereto a schedule listing each of Phillips' rate schedules shown on Exhibit 357 (which constitutes the major sales of Phillips in effect during the hearing) showing the price actually in effect on April 1, 1959, the volumes delivered in 1958, and the "calculated rate" which would be applicable to each such sale. Volumes are shown on the same basis as in said exhibits. By a comparison of the volumes and prices shown on this schedule with the volumes and prices shown correspondingly for each rate schedule on Exhibits 324 and 357, we believe it will be possible for any Intervenor to make its own computation of the impact which the decision would have upon it.

It should be clearly understood that this information is being furnished merely as an assistance to the Intervenors and is without prejudice to any position which Phillips may take with respect to the Examiner's decision. Specifically, by furnishing this information Phillips does not agree that any particular action is required of Phillips by the terms of the Examiner's decision or admit that the decision is applicable to any particular sale. Moreover, the "maximum rate" of 15¢ per Mcf

is based upon an average rate of 11.662¢ per Mcf as determined in the Examiner's decision. Phillips believes that,

for reasons which will be stated in formal exceptions to the Examiner's decision which will be filed, this average rate of 11.662¢ per Mcf is incorrect and should be increased. If this average rate is ultimately determined to be higher than 11.662¢ per Mcf, then correspondingly, the "maximum rate" will be higher than 15¢ per Mcf and each of the "calculated rates" will likewise be higher.

A copy of this letter and the attached schedule are being sent to each party of record.

Respectfully submitted,

By /s/ KENNETH HEADY
Kenneth Heady
Attorney
Phillips Petroleum Company

KH:rb
Attachment

PHILLIPS PETROLEUM COMPANY & SUBSIDIARIES
1958 VOLUMES, APRIL 1 1959 RATES & RATES COMPUTED ON BASIS OF EXAMINER'S COST OF SERVICE FOR RATE SCHEDULES LISTED ON EXHIBIT 357

F.P.C. RS No.	Purchaser	Source of Gas	1958 Volume Mcf @ 14.65	Rates @ 14.65 Psia April 1, 1959 Approved for Collection (A)	Rates @ 14.65 Psia Computed from Examiner's Cost of Service
1-A	United Gas P. L. Co.	Wellhead	137,268	6.615c	13.75c
2-A	Texas Eastern Trans. Corp.	Wellhead	2,614,266	13.920c	12.80c
3	Tennessee Gas Trans.	System	101,867	12.123c	15.00c
4	Michigan-Wisconsin P. L.	Sherman Plant—Stratford	21,707,813	11.473c	12.75c
		Sherman Plant—Okla.	6,627,774	11.405c	12.75c
		Sherman Plant—Texas	86,870,811	11.522c	12.75c
5	Panhandle Eastern P. L. Co.	Hansford Plant—Texas	14,520,016	6.967c	13.00c
		Hansford Plant—Okla.	12,960,710	6.889c	13.00c
		Sneed Plant	21,338,452	6.967c	12.75c
7	El Paso Natural Gas Co.	Goldsmith Plant	5,320,829	10.255c	10.25c
9	El Paso Natural Gas Co.	Crane Plant	9,706,586	8.335c*	10.00c
10	El Paso Natural Gas Co.	Keystone Plant	1,750,555	10.446c	13.25c
13	United Gas P. L. Co.	Wellhead	3,162,996	9.622c	13.15c

* Contract rate of 9.934c adjusted to volume shown.

** Pipeline Volume.

RS No. F.P.C.	Purchaser	Source of Gas	1958 Volume Mcf @ 14.65	Rates @ 14.65 psia April 1, 1959 Approved for Collection (A)	Computed from Examiner's Cost of Service
18	Permian Basin P. L. Co.	Benedum Plant	1,447,596	11.066c	11.00c
		Andrews Plant	23,617,836	11.066c	11.00c
		Spraberry Plant	7,143,585	11.066c	11.00c
		Pembrook Plant	24,341,040	11.060c	11.00c
		Wellhead—Devonian	8,858,071	15.144c	13.15c
		Wellhead—Ellenberger	24,948,718**	10.096c	8.15c
19	Consolidated Gas Util. Co.	Lefors Plant	12,217,284	13.673c	13.15c
20	Tennessee Gas Trans. Co.	Wellhead	25,294	11.903c	13.15c
21	Colorado Interstate Gas Co.	Sanford Plant	14,402,045	16.154c	11.60c
23	Texas Gas Trans. Corp.	Carthage Plant	860,073	10.610c	14.25c
24	Northern Natural Gas	Dumas Plant	14,371,229	13.940c	12.75c
27	Texas-Ill. Nat. Gas P. L.	Chocolate Bayou Plant	10,834,772	10.449c	15.00c
31	Arkansas-Louisiana Gas	Wellhead	342,536	11.505c	12.45c
32	El Paso Natural Gas	Goldsmith Plant	24,526,443	10.255c	10.25c
		Eunice Plant	12,603,052	10.170c	10.25c
		Fullerton Plant	5,059,322	10.255c	10.25c
		Dumas Plant	39,282,152	13.528c	12.75c
		31770			
33	El Paso Natural Gas Co.	Goldsmith Plant	20,052,764	10.255c	10.25c
34	Tennessee Gas Trans.	Wellhead	80,079	13.278c	13.75c
39	Tennessee Gas Trans.	Wellhead	68,831	13.498c	14.00c
41	Texas-Illinois Nat. Gas	Chocolate Bayou Plant	2,338,591	15.811c	15.00c
42	Texas Gas Corp.	Wellhead	131,760	11.106c	13.75c

(31770)

RS No. F.P.C.	Purchaser	Source of Gas	1958 Volume Mcf @ 14.65	Rates @ 14.65 psia April 1, 1959 Approved for Collection (A)	Computed from Examiner's Cost of Service
47	El Paso Natural Gas Co.	Wellhead	381,432	10.601c	13.15c
48	Arkansas-La. Gas Co.	Wellhead	266,567	12.240c	14.75c
52	Panhandle Eastern P. L. Co.	Wellhead	205,183	2.233c	9.50c
59	Permian Basin P. L.	Wellhead	569,654	9.500c	12.05c
61	Panhandle Eastern P. L. Co.	Wellhead	5,734,647	3.910c	9.50c
64	El Paso Natural Gas Co.	Eunice Plant	13,751,895	10.170c	10.25c
65	El Paso Natural Gas Co.	Wellhead	687,140	10.500c	12.05c
66	El Paso Natural Gas Co.	Denton Plant	342,775	11.509c	14.50c
68	Cities Service Gas Co.	Edmond Plant	1,377,538	7.603c	14.00c
69	Cities Service Gas Co.	Hunton & Trindle Plants	329,413	6.700c	14.00c
82	Shamrock Oil & Gas Corp.	Wellhead	139,748	8.500c	9.10c
140	Breckenridge Gasoline Co.	Wellhead	148,086	7.542c	12.80c
143	Panhandle Eastern P. L. Co.	Wellhead	239,106	3.127c	9.50c
145	Texas Gas P. L. Co.	Wellhead	940,477	12.731c	13.15c
148	Ryeade Oil Corp.	Wellhead	61,416	7.00 c	10.35c
149	Transcontinental Gas P. L. Co.	System	805,562	17.063c	14.50c
150	Consolidated Gas Util. Corp.	Wellhead	263,275	11.00 c	10.75c
175	Southern Natural Gas Co.	System	1,139,280	14.123c	15.00c
187	Tennessee Gas Trans. Co.	System	Cancelled		
188	El Paso Natural Gas Co.	Wellhead	Rejected		
202	Texas Northern Gas Corp.	Wellhead	343,335	20.291c	14.00c
209	Tennessee Gas Trans. Co.	Wellhead	549,011	13.278c	13.75c
216	United Gas P. L. Co.	Wellhead	266,913	6.445c	12.80c
217	United Gas P. L. Co.	Wellhead	Withdrawn		

RS No. F.P.C.	Purchaser	Source of Gas	1958 Volume Mcf @ 14.65	Rates @ 14.65 psia April 1, 1959 Approved for Collection (A)	Rates @ 14.65 psia Computed from Examiner's Cost of Service
218	Tennessee Gas Trans. Co.	Wellhead	664,778	21.288c	14.00c
219	Southern Natural Gas Co.	System	3,841,480	21.450c	14.50c
220	Transcontinental Gas P. L. Co.	Wellhead	507,072	17.063c	13.75c
229	Northern Utilities Co.	Wellhead	Withdrawn		
231	Tennessee Gas Trans. Co.	Wellhead	180,777	13.278c	13.75c
239	Miss. River Fuel Corp.	Hico Knowles Plant	391,576	12.922c	15.00c
243	El Paso Natural Gas Co.	Lee Plant	4,223,440	10.805c	12.00c
		Hobbs Plant	7,050,487	10.170c	10.25c
		31771			
252	Northern Nat. Gas Co.	Wellhead	657,434	13.083c	12.80c
262	Northern Nat. Gas Co.	Gray Plant	17,679,856	13.630c	11.00c
270	Panhandle Eastern P. L. Co.	Wellhead	658,282	10.000c	9.50c
273	United Fuel Gas Co.	Erath Plant	7,965,143	21.743c	15.00c
		No. Erath & Erath Shallow	6,603,518	21.743c	15.00c
274	El Paso Nat. Gas Co.	Wellhead	231,249	10.500c	12.40c
276	Louisiana Nevada Transit Co.	Wellhead	48,752	11.700c	12.45c
278	American Louisiana P. L. Co.	System—Bourque Unit	525,697	20.963c	14.75c
279	Pacific Northwest P. L. Corp.	Wellhead	497,422	18.038c	12.45c
W.E.#1	Cities Service Gas Co.	Hunton & Trindle Plant	37,906	6.700c	14.00c
W.E.#2	Cities Service Gas Co.	Edmond Plant	132,140	7.603c	14.00c

(A) Includes tax reimbursement.

RLH:amp
5-6-59

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(31771)

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31855

Order Denying Motion

(Issued July 17, 1959)

On June 25, 1959, El Paso Natural Gas Company (El Paso) filed a motion requesting that the Commission require Phillips Petroleum Company (Phillips) to comply fully with the Presiding Examiner's decision issued herein on April 6, 1959 and to extend the time for filing of exceptions to said examiner's decision for a period of 30 days from the date on which said compliance is made. In its motion, El Paso cited paragraphs (A) and (B) as set forth at pages 314-315 of the aforementioned decision and stated, among other things, that, while such paragraphs unequivocally require Phillips to submit data respecting both the "maximum rate" and the "calculated rates" within 60 days following the issuance of such decision, Phillips has not complied therewith. El Paso also states that Phillips, by letter dated May 28, 1959, submitted to the Commission certain data and information which apparently is intended to satisfy requests contained in certain motions [1] for Phillips to calculate and publicize the rates which it would propose to place in effect if such decision were to be adopted by the Commission as well as to comply with the provisions of said paragraphs (A) and (B). El Paso asserted that Phillips submittal suggests a "maximum rate" as required

[1] On April 17, 1959, Northern Natural Gas Company and Permian Basin Pipeline Company filed a motion with the Commission, requesting, *inter alia*, that Phillips make known to those companies the "calculated rates" required by the Examiner's Decision for sales of natural gas under all contracts which Phillips has with those companies. Subsequently, Southern California Gas Company, Southern Counties Gas Company of California, Pacific Gas & Electric Company and San Diego Gas and Electric Company filed motions with the Commission seeking similar information and, additionally, a comparison of the "calculated rates" with the actual rates in effect on April 1, 1959, together with the volumes for the year 1958 applicable thereto.

by said paragraph (A) of "approximately 15¢ per Mcf at 14.65 psia" and lists "calculated rates" for only a portion of

Dockets Nos. G-1148, *et al.*

Panhandle Eastern Pipe Line Company on July 2, 1959, and Phillips on July 6, 1959, filed answers to El Paso's motion stating, in effect, that (1) Phillips, by its letter of May 28, 1959, furnished to all parties a statement of the approximate calculated rates applicable to the rate schedules which account for more than 95% of its jurisdictional gas sales volume and advised the Commission that some of the information which would be needed "is not readily available, even to Phillips"; (2) that the Presiding Examiner has not attempted to require Phillips to submit such data; (3) that said paragraphs (A) and (B) are clearly contingent upon the Commission's prior adoption of the Examiner's conclusion in that the introductory portion of the proposed order (p. 314) states that it is "subject to review by the Commission on appeal"; and (4) that, inasmuch as the Secretary of the Commission extended the time for filing exceptions herein to and including July 27, 1959, the said decision is not final. In addition, Phillips stated (1) that it had received no indication that the said furnished information was not fully satisfactory to the parties who requested it; (2) that representatives of the Eastern Seaboard Intervenors, the Southern California Companies, and Panhandle Eastern Pipe Line Company have in informal discussions indicated their satisfaction with the material furnished;[2] and (3) that as El Paso did not originally request the information, that "under these circumstances it is apparent that El Paso's motion can have no basis except delay."

[2] Northern Natural Gas Company and the Southern California Companies have so advised the Commission.

Inasmuch as the Presiding Examiner's decision herein is still subject to review by the Commission on appeal or upon its own motion as provided in the Commission's Rules of Practice and Procedure, it is considered that, at this time, the delay necessitated in effecting El Paso's request would not be warranted.

The Commission finds:

Good cause has not been shown for granting El Paso's request.

The Commission orders:

El Paso Natural Gas Company's motion filed June 25, 1959 is denied.

By the Commission.

32397

Exceptions By the Public Utilities Commission of the State of California to Intermediate Decision.

Comes now the Public Utilities Commission of the State of California (California) and pursuant to Section 1.31 of the Rules of Practice and Procedure of the Federal Power Commission, does hereby appeal to the Commission from and files exceptions to the decision of the Presiding Examiner in the above-entitled matter filed on April 6, 1959.

INTRODUCTION AND COMMENT.

The Zwerdling decision is the first step toward producer regulation based upon conventional utility type cost of service theories. In general, California supports the Examiner's decision particularly against those expected criticisms that its allowances to Phillips are unrealistic and conservative. Insofar as the decision attempts to fix just and reasonable prices through the vehicle of cost of service approach, California supports it save for the exceptions hereinafter set forth.

EXCEPTION No. I

A. California excepts to the following portion of the Decision appearing at pages 294-5:

> "After considering all of the matters outlined above, it is here concluded that the system-wide rate approach represents a satisfactory and appropriate method for the fixing of 'just and reasonable' producer rates, for the following reasons:

"(1) It is inherently simple to administer.

"(2) It would be fair to the producer, in the sense that it permits him to recover his total cost of service in one way or another.

"(3) It would eliminate unreasonable preferences currently enjoyed by pipelines which are still purchasing gas under old, abnormally low-priced contracts—preferences which are based not merely upon differences in cost levels, but which reflect other historic reasons.

"(4) Although the effect of a system-wide rate would be that pipelines such as Panhandle and El Paso, which are presently enjoying abnormally low prices under certain old, long-term gas supply contracts, should be required to pay a higher price level under such contracts, this would be only a short-term, temporary disadvantage. Furthermore, any such temporary disadvantage would be counterbalanced by the fact that their necessary purchases of additional gas reserves from more recently developed and higher-cost areas would be made at lower rates than would have resulted under an area-pricing method."

SUPPORTING REASONS

The system-wide uniform rate which the decision employs results in the postage stamp type of rate. Such a rate ignores relationship between costs and revenues. It ignores the fundamental principle of rate making that the ratepayer should pay only for the service benefits furnished them. It ignores the differences between customers of Phillips and the facilities which serve them. It does not take into consideration the variety of production costs as they exist between different supply areas.

Natural Gas Act, Sec. 4(b)
Transcript, Vol. 96, p. 12,787
Transcript, Vol. 101, p. 13,345
Transcript, Vol. 101, p. 13,399
Transcript, Vol. 101, p. 13,401

32399

PROPOSAL

California proposes the deletion of those portions of the Examiner's opinion to which exceptions are taken. In lieu of such deleted portions, California proposes the following: "The system-wide rate approach or the so-called postage stamp type of rate is neither suitable to nor required by all of the sales of natural gas by Phillips. A single over-all rate is not proper because it would result in undue preferences contrary to the Natural Gas Act. Consumers should be required to pay only their proper and reasonable portion of the expense of gas purchases devoted to their needs. An area cost of production should be adopted based upon the record herein."

EXCEPTION NO. II

California excepts to that portion of the decision wherein a 9.25 percent rate of return is allowed.

SUPPORTING REASONS

Natural Gas Act, Section No. 4(a)

Phillips is a corporation operating within a regulated industry. It is committed by law to rendering charges at the lowest reasonable rates.

State of Missouri ex rel Southwestern Bell Telephone Company, plf. in Error vs. Public Service Commission of Missouri, et al., 262 U.S. 276.

(32399)

The record shows that the Witness Colbert testifying on behalf of Wisconsin presented testimony and evidence supporting an over-all rate of return of 7.75 per cent. This in itself is somewhat beyond the usual rate of return. However, the Commission should adopt this rather than the Zwerdling figures.

32400

PROPOSAL

California proposes the deletions of those portions of the Examiner's opinion permitting a rate of return of 9.25 percent and would substitute in lieu thereof the following language:

"Phillips' rate of return herein based upon the evidence received should not be in excess of 7.75 percent."

EXCEPTION No. III

California excepts to the omission in the decision of a finding that Phillips' spiral escalation clauses are contrary to the public interest and void for regulatory purposes under the Natural Gas Act.

SUPPORTING REASONS

Phillips is now a regulated producer. This Commission by law may only recognize actual costs as the basis for any present or future rate increases.

PROPOSAL

California proposes in lieu thereof: "Those spiral escalation provisions existent in Phillips' contracts with its purchasers are contrary to the Natural Gas Act and will not be recognized by this Commission as the basis for

proposed or requested increased rates absent the occurrence of actual reasonable cost."

Respectfully submitted,

/s/ WILLIAM M. BENNETT
William M. Bennett
Chief Counsel

/s/ RODERICK B. CASSIDY
Roderick B. Cassidy
Assistant Chief Counsel
Attorneys for the People of the State of California and the Public Utilities Commission of said State
514 State Building
San Francisco, California

Dated: July 31, 1959

* * * * * * * * * * *

32539

PHILLIPS PETROLEUM COMPANY

Bartlesville, Oklahoma

April 6, 1960

Offer of Settlement —
Docket No. G-1148, et al.

Federal Power Commission
441 G Street, Northwest
Washington 25, D. C.

Gentlemen:

Nearly twelve years ago, the Federal Power Commission first instituted the proceeding in Docket No. G-1148. Since then, the Commission has found that Phillips was not a natural gas company within the meaning of the Natural Gas Act, was reversed by the Supreme Court on that ruling, held lengthy hearings under Section 5(a) of the

Natural Gas Act commencing in June, 1956, and, in October, 1959, heard oral arguments on exceptions to the Examiner's decision. Phillips—indeed, the entire natural gas industry—has been operating for a long time in a state of indecision and confusion.

During the hearings under Section 5(a), the Federal Power Commission Staff, Phillips, and numerous intervenors presented various costs of service and various methods of setting or changing rates in order to produce some specific cost of service. Phillips' calculation of its cost of service for the test year of 1954 was $92.3 million, as compared with revenues as of late 1956 of $48.3 million. Every cost of service offered by the Staff and intervenors (there were 63 pipelines, distributors, state commissions and municipal bodies permitted to intervene in the proceedings), regardless of how computed, exceeded Phillips' revenues—the only question was the degree. The method of fixing rates to return the cost of service (whatever it might be) was the subject on which there was the greatest lack of agreement.

During and since the hearing, Phillips' rates for many of those sales involved in the 1954 test year have been increased, both by contractual provisions and by renegotiation of contracts providing, among other things, for the removal of indefinite pricing provisions. As a result, Phillips, although it is not yet recovering its true cost of service, has reduced its deficiency materially. Phillips does not recede from its position that the the $92 million cost of service which it put in evidence in Docket No. G-1148 is its true cost of service, or that it is entitled to recover that cost of service from its jurisdictional sales. However, considering the almost endless confusion and delay (and possible serious economic consequences for certain of Phillips' customers) which would ensue were the Commis-

sion to attempt, by *any* method, to determine new prices for

each of Phillips' contracts which, in the aggregate, would return Phillips', or any other, cost of service, Phillips hereby makes the following offer of settlement. Such settlement offer is based entirely on the prices contracted between Phillips and its purchasers, and for the purposes of this settlement, Phillips waives its right to higher rates which would return to it its true cost of service. Specifically, Phillips offers to settle the proceedings involved in Docket No. G-1148, et al. on the following basis:

1. With respect to those rate schedules included in Docket No. G-1148, et al., the contract prices as of the date of the Commission's order would be approved.

2. With respect to those rate schedules included in Docket No. G-1148, et al., all price increases now being collected subject to refund would be approved and the proceedings terminated without refund.

3. Such new rates as may be ultimately agreed upon under rate schedules 4 and 19 (subject to the limitation shown in Schedule II attached hereto), which are now being renegotiated, would be approved as of such time as the amended rate schedules are filed with the Commission.

4. The Commission would terminate without refund all Section 4(e) proceedings involving rate schedules not included in Item 1 above.

Phillips is induced to make this offer for the following reasons:

1. Any system or method of determining individual rates to meet a specific cost of service would undoubtedly be assailed in the courts by practically all parties, thus even further prolonging a final decision in the matter. On the other hand, by approving the prices agreed to by contract with our pipeline purchasers, at least the objections of that group of intervenor-protestants would be eliminated, since

it is a reasonable assumption that such purchasers would not challenge prices under contracts which they have voluntarily entered into.

2. The elimination of the problem of determining specific individual rates (188 separate rate schedules) will permit an earlier conclusion to this proceeding, which will be of great benefit to the Commission, its Staff, and all segments of the natural gas industry.

3. The uncertainties with respect to natural gas prices at the producer and consumer level growing out of this proceeding which has been pending nearly six years will be eliminated.

4. Regardless of the circumstances, almost every rate increase filed by Phillips since June 7, 1954, has been suspended and is being collected subject to refund. The amounts so collected are substantial and are increasing each month. If allowed to continue, Phillips' exploratory program may be adversely affected.

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As shown in the attached schedules I through IV, the annual revenue to Phillips at April 1, 1960 contract prices, from the contracts which were the subject of the hearing in Docket No. G-1148, et al. (subject to notations in the attached schedules as to specific prices now being renegotiated) amounts to $70.8 million. These prices are amply justified by its cost of service of $92.3 million and by the Examiner's cost of service when it is adjusted for its obvious errors with respect to statutory tax allowances and increased gas purchase costs, and for appropriate adjustments to the allowance for exploration. With respect to the Section 4(e) proceedings referred to in Item 4 on Page 2, which are not directly subject to these proceedings, a comparison of the contract prices in those proceedings

with contract prices in Item 1 on Page 2 amply supports the termination of such Section 4(e) proceedings. The attached Schedule V shows both Phillips' and the Examiner's costs of service, together with a series of costs of service reflecting various adjustments.

RBS:omr
Enclosures

Very truly yours,

R. B. STEWART
R. B. Stewart, Vice President
Natural Gas Department

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SCHEDULE I

SUMMARY OF REVENUES AT APRIL 1, 1960 CONTRACT PRICES UNDER RATE SCHEDULES INCLUDED IN EXHIBITS 288 AND 289 OF G-1148

Type	1954 Volumes, Mcf @ 14.65	Revenues April 1, 1960 Contract Prices, Dollars
Rate schedules under which deliveries were made in 1954 and which are still in effect on April 1, 1960 (see SCHEDULE II).	431,481,254	$64,298,993
Rate schedules under which deliveries were made in 1954, but which have been terminated as of April 1, 1960 (see SCHEDULE III).	38,934,240	5,075,447
Deliveries under casinghead-type contracts which had been filed as rate schedules (See SCHEDULE IV).	20,716,526	1,463,009
Exchange (R.S. 212)	46,933	4,693
TOTAL	491,178,953	$70,842,142

SCHEDULE H

REVENUES FROM RATE SCHEDULES
LISTED IN EXHIBITS 288 AND 289 OF G-1148
STILL IN EFFECT AS OF APRIL 1, 1960

Rate Schedule Number	April 1, 1960 Contract Price* ¢/Mcf @ 14.65	Indicated Revenue, Dollars	1954 Volume Mcf @ 14.65
1-A	6.6806	87,858	5,869
2-A	14.8000	2,477,038	366,602
3	17.2435	165,333	28,509
4	16.5000**	126,671,655	20,900,823
5	13.0000	52,531,706	6,829,122
6	9.5861	28,798	2,759
7	13.6175	122,560	16,687
9 (8)	13.3632	7,355,245	982,896
10	16.1286 (a)	2,054,887	331,425
13	9.6216	3,047,243	293,194
17	10.6722	76,781	8,194
18 (Plants)	11.0661	26,853,264	2,971,609
(Puckett)	11.1056 (b)	5,862,642	—
	P. L. Volume	(3,693,992)	410,240
19	17.0000**	12,155,597	2,066,451
20	17.0242	275,340	46,874
21	17.1632	14,565,740	2,499,947
22	14.1344	40,923	5,784
23	10.6105	809,060	85,845
27	10.8951	10,220,000	1,113,479
29	15.3333	61,583	9,443
30	17.2435	65,492	11,293
31	11.5055	714,458	82,202
32 (Goldsmith)	13.6155	25,600,659	3,485,658
(Eunice)	3.5330	12,433,435	1,682,617
(Fullerton)	13.6155	5,889,576	801,895
(Dumas)	19.7632	38,780,996	7,664,366
33	13.6155	8,577,295	1,167,842
34	15.9502	183,328	29,241
36	15.9502	107,581	17,159
37	8.8733 (c)	53,709	4,766
38	7.4950 (d)	22,482	1,685
39	16.1695	167,488	27,082
40	15.2025	122,481	18,620
41	15.8106	6,503,518	1,028,245

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Rate Schedule Number	April 1, 1960 Contract Price* ¢/Mcf @ 14.65	Indicated Revenue, Dollars	1954 Volume Mcf @ 14.65
42	9.0864(e)	150,976	13,718
43	17.0242	47,430	8,075
47	15.7092	1,292	203
48	12.2410	20,839	2,551
53	9.0397	12,219	1,105
56	7.4561	120,549	8,988
57	16.0000	13,885	2,222
58	8.0512	29,948	2,411
59	10.766	408,304	43,969
	32544		
60	7.5000	99,173	7,438
62	12.5007	107,924	13,491
63	8.9808	278,014	24,968
64	13.5330	13,476,859	1,823,823
65	15.5598	505,830	78,706
66	17.0436	251,808	42,917
68	7.5930	6,477,720	491,853
69	6.6997	1,282,711	85,938
81	9.0000	54,131	4,872
83	8.5000	226,468	19,250
140	6.0424(f)	255,633	15,446
144	3.7965	422,455	16,039
148	7.0000	180,697	12,649
150	11.0000	185,466	20,401
151	15.1131	54,160	8,185
158	11.0000	26,291	2,892
175	14.1240	1,370,081	193,510
183	11.7518	108,068	12,700
189	10.9626	102,037	11,186
200	15.9502	118,274	18,865
202	20.1916	301,220	61,122
209	15.9502	192,035	30,630
216	20.2916	285,023	57,836
218	22.2634	331,990	73,912
219	23.0841	1,097,355	253,315
220	22.9622	513,047	117,807
231	15.9502	243,943	38,909
239	12.9225	470,339	60,780
241	9.7229	10,196	991
243 (Lee)	14.0343	3,342,639	469,116
(Hobbs)	13.5330	5,820,272	787,657

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Rate Schedule Number	April 1, 1960 Contract Price* ¢/Mcf @ 14.65	Indicated Revenue, Dollars	1954 Volume Mcf @ 14.65
258 (214)	6.5000	143,072	9,300
262 (26, 28)	18.9300	17,914,056	3,391,131
310 (242)	7.8003	4,133	322
323 (70)	13.3000	6,036	803
324 (159)	13.3000	7,518	1,000
356 (52, 61, 143, 270)	10.0000	9,164,854	916,485
W.E. #1	6.6997	148,459	9,946
W.E. #2	7.5930	410,074	31,137
TOTAL		431,481,254	$64,298,993

(See footnotes on following page.)

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FOOTNOTES

*Contract price shown includes tax reimbursement, but is after certain deductions by the purchaser as indicated by the footnotes below:

(a) After deduction of 1.0¢ per Mcf for sour, undehydrated gas.
(b) After deduction of 5.0¢ per Mcf for treating.
(c) After deduction of 5.0¢ per Mcf for compression.
(d) After deduction of 0.5¢ per Mcf for gathering.
(e) After deduction of 2.0¢ per Mcf for compression.
(f) After deduction of 1.5¢ per Mcf for compression.

**The prices shown are not the current contract prices. Phillips is renegotiating these contracts and the prices shown here are the maximum prices being considered in these negotiations.

SCHEDULE III

REVENUES FROM RATE SCHEDULES LISTED IN EXHIBITS 288 AND 289 OF G-1148 UNDER WHICH DELIVERIES HAVE BEEN TERMINATED AS OF APRIL 1, 1960

Rate Schedule Number	Contract Price at Date* of Termination ¢/Mcf	1954 Volume Mcf @ 14.65	Indicated Revenue, Dollars	Certificate Docket No.	Abandonment Docket No.	Rate Schedules Rejected or Withdrawn
24	14.4443	18,541,588	$2,678,203	G-2620	G-18113	
25	10.7187	25,063	2,686	2615		Yes
35	13.1870	128,163	16,901	2608		Yes
55	7.0250	124,626	8,755	3338		Yes
77	5.5000	101,237	5,568	3369	10054	
78	5.5000	95,814	5,270	3370	10055	
82	14.0000	12,890,127	1,804,618	3897	11686	
152	7.5000	140,130	10,510	3440		Yes
157	11.0000	93,705	10,308	3444	18524	
169	4.1295	11,321	468	3501		Yes
181	3.7283	2,385,293	88,931	4179		Yes
186	11.7000	17,715	2,073	3471		Yes
187	9.9707	1,550,144	154,560	3824		Yes
188	10.5000	184,002	19,320	3472		Yes
192	4.7846	97,166	4,649	3476	8893	
193	4.7762	55,268	2,640	3477	8893	
194	4.5115	50,951	2,299	3478	8893	
197	11.7000	155,942	18,245	3471		Yes
198	10.7250	20,329	2,180	3471		Yes
217	10.2352	844,010	86,386	3497		Yes
222	2.6332	100,690	2,651	3505	8756	
228	11.7000	118,403	13,853	3471		Yes
229	7.8000	161,534	12,600	3511		Yes
230	11.7000	956,951	111,963	3471		Yes
232	11.7000	4,169	488	3471		Yes
233	11.7000	40,994	4,796	3471		Yes
235	11.7000	18,857	2,206	3471		Yes
236	10.7250	1,228	132	3471		Yes
237	10.7250	1,431	153	3471		Yes
248	11.7000	17,389	2,035	3471		Yes
TOTAL		38,934,240	$5,075,447			

*Contract price shown includes tax reimbursement. Rate schedules 192, 193, and 194 were percentage type casinghead contracts and the prices shown are average unit revenues based on the last year's deliveries.

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SCHEDULE IV

REVENUES UNDER CASINGHEAD-TYPE CONTRACTS
FILED AS RATE SCHEDULES AND INCLUDED
IN EXHIBIT 288 OF G-1148

Rate Schedule Number	1954 Volume Mcf @ 14.65	1958 Unit Revenue* ¢/Mcf @ 14.65	Indicated Revenue, Dollars
16	18,900	4.8593	918
44	42,687	6.1291	2,616
46	29,351	5.0130	1,471
49	5,235	11.9617	626
51	91,890	2.5269	2,322
67	219,405	4.0739	8,938
71	96,047	12.5932	12,095
72	59,399	10.0227	5,953
73	45,488	8.7502	3,980
74	21,002	8.7639	1,841
79	97,371	5.3425	5,202
80	3,080,912	7.5563	232,803
84	3,280,296	7.6378	250,542
85	192,890	7.8629	15,167
86	43,404	7.8772	3,419
87	35,942	7.8932	2,837
88	43,534	8.0792	3,517
89	36,889	7.8520	2,896
90	97,059	7.4782	7,258
91	152,791	7.5776	11,578
92	63,985	7.8873	5,047
93	100,859	7.6542	7,720
94	18,207	7.8596	1,431
95	74,125	8.2844	6,141
96	36,287	7.8547	2,850
97	107,547	5.2175	5,611
98	31,495	3.2806	1,033
99	28,554	4.5321	1,294
100	154,174	5.7436	8,855
101	87,525	4.6950	4,109
102	462,899	4.2833	19,827
103	4,344,778	3.1595	137,273
104	121,897	7.7855	9,490
105	544,971	10.2181	55,686
106	39,169	5.3576	2,099

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Rate Schedule Number	1954 Volume Mcf @ 14.65	1958 Unit Revenue* ¢/Mcf @ 14.65	Indicated Revenue, Dollars
107	805	4.3478	35
108	32,926	4.5946	1,513
109	3,387	4.4697	151
110	138,764	8.3166	11,540
111	84,945	4.6562	3,955
112	4,151	6.0312	250
113	32,288	5.3973	1,743
114	403	5.3218	21
115	26,222	10.9982	2,884
	32548		
116	204,603	10.2976	21,069
117	538,121	5.7224	30,793
118	1,650	9.2767	153
119	5,301	5.1100	271
120	101,483	4.7990	4,870
121	22,823	5.2381	1,195
122	36,410	7.5135	2,736
123	232,046	11.5244	26,742
124	619,703	10.3458	64,113
125	191,436	6.0762	11,632
126	406,922	6.0078	24,447
127	34,931	7.2141	2,520
128	9,317	10.1207	943
129	123,711	7.1212	8,810
130	37,083	10.8685	4,030
131	11,352	6.4572	733
132	75,577	10.6087	8,018
133	103,340	12.5289	12,947
134	61,447	8.6323	5,304
135	41,711	8.8020	3,671
136	36,867	13.1490	4,848
137	46,195	12.7013	5,867
138	66,068	7.2853	4,813
139	14,806	12.0996	1,791
141	36,985	6.1639	2,280
142	71,013	7.6115	5,405
146	607,118	8.7601	53,184
147	36,003	3.2873	1,184
153	1,382	12.6214	174
154	74,026	6.2096	4,597
155	39,305	21.7206	8,537
156	8,734	2.6591	232

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Rate Schedule Number	1954 Volume Mcf @ 14.65	1958 Unit Revenue* ¢/Mcf @ 14.65	Indicated Revenue, Dollars
160	7,382	5.9049	436
161	39,197	4.2690	1,673
162	424	3.5165	15
163	68,901	6.1150	4,213
164	5,588	5.9571	333
165	396,260	5.9972	23,765
166	1,174	6.1844	73
168	16,316	4.4223	722
170	16,921	7.8596	1,330
171	14,614	7.8596	1,149
172	27,760	7.8596	2,182
173	9,320	5.6734	529
174	765	5.0633	39
179	175,813	5.5000	9,670
		32549	
180	46,926	5.2979	2,486
182	57,572	15.0952	8,691
184	37,216	2.8611	1,065
185	30,849	3.0569	943
190	1,695	6.3380	107
191	13,969	4.6320	647
199	203,440	5.5765	11,345
203	18,271	7.9592	1,454
204	10,057	7.0014	704
205	128,330	6.2356	8,002
210	110,687	4.8490	5,367
223	7,552	7.3794	557
224	219,616	9.0741	19,928
225	190,420	12.3310	23,481
226	22,878	5.3206	1,217
238	13,796	6.3051	870
244	145,691	14.0200	20,426
245	416,003	25.9279	107,861
250	98,997	5.3115	5,258
P.C.C. #1	33,584	5.9900	2,012
P.C.C. #2	218	5.9900	13
TOTAL	20,716,526		$1,463,009

*Unit revenue for each contract was obtained by dividing total revenue by wellhead volume. Data for 1958, the latest available, was used unless deliveries ceased in some prior year, in which case the unit revenue for that last year of deliveries was used.

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SCHEDULE V

PHILLIPS PETROLEUM COMPANY AND SUBSIDIARIES
DOCKET NO. G-1148
EFFECT OF VARIOUS ADJUSTMENTS AS BETWEEN
PHILLIPS' AND THE EXAMINER'S COST OF SERVICE

Line No.		I	II	III	IV	V	VI	VII	VIII	IX	Line No.
		Phillips								Examiner	
1.	Rate of Return	12%	12%	12%	12%	12%	9.25%	9.25%	9.25%	9.25%	1.
2.	Total Provision for Fed. Income Taxes Includes	Tax Benefits	Tax Benefits	Tax Benefits	Tax Benefits	Tax Benefits	Tax Benefits	Tax Benefits	Tax Benefits	No Tax Benefits	2.
3.	Exploration Allocated to Gas	59.5404%	59.5404%	45.2242%*	43.25%***	41.25%**	45.2242%*	43.25%***	41.25%**	30.4596%	3.
4.	Components of Rate Base										4.
5.	Natural Gas Leases	$31,174,819	$ 31,174,819	$ 31,174,819	$ 31,174,819	$ 31,174,819	$ 31,174,819	$ 31,174,819	$ 31,174,819	$ 31,157,055	5.
6.	Joint Product Leases—Gas	23,942,940	23,942,940	23,942,940	23,942,940	23,942,940	23,942,940	23,942,940	23,942,940	23,929,281	6.
7.	Gathering Systems	29,635,783	29,635,783	29,635,783	29,635,783	29,635,783	29,635,783	29,635,783	29,635,783	29,612,385	7.
8.	Residue Systems	2,763,353	2,763,353	2,763,353	2,763,353	2,763,353	2,763,353	2,763,353	2,763,353	2,763,352	8.
9.	Subtotal	87,516,895	87,516,895	87,516,895	87,516,895	87,516,895	87,516,895	87,516,895	87,516,895	87,462,073	9.
10.	Exploration	34,114,490	34,114,490	25,857,028	24,728,275	23,584,771	25,857,028	24,728,275	23,584,771	17,405,416	10.
11.	Subtotal	121,631,385	121,631,385	113,373,923	112,245,170	111,101,666	113,373,923	112,245,170	111,101,666	104,867,489	11.
12.	Working Capital—Less ⅓ Actual Fed. Income Taxes	—0—	5,475,176	5,581,750	5,596,042	5,610,525	6,531,639	6,537,731	6,543,904	8,028,654	12.
13.	Total Rate Base	$121,631,385	$127,106,561	$118,955,673	$117,841,212	$116,712,191	$119,905,562	$118,782,901	$117,645,570	$112,896,143	13.
14.											14.
14.	Cost of Service										14.
15.	Direct Lease Expense	$ 4,657,810	$ 4,657,810	$ 4,657,810	$ 4,657,810	$ 4,657,810	$ 4,657,810	$ 4,657,810	$ 4,657,810	$ 4,655,156	15.
16.	Indirect Lease Expense	5,355,255	5,355,255	5,355,255	5,355,255	5,355,255	5,355,255	5,355,255	5,355,255	5,651,952	16.
17.	Gathering & Residue Systems Expense	8,580,546	8,580,546	8,580,546	8,580,546	8,580,546	8,580,546	8,580,546	8,580,546	8,574,468	17.
18.	Gas Purchases	18,262,419	18,262,419	18,262,419	18,262,419	18,262,419	18,262,419	18,262,419	18,262,419	18,248,001	18.
19.	Regulatory Expense	400,000	400,000	400,000	400,000	400,000	400,000	400,000	400,000	400,000	19.
20.	Subtotal	37,256,030	37,256,030	37,256,030	37,256,030	37,256,030	37,256,030	37,256,030	37,256,030	37,529,577	20.
21.	Exploration Expense	15,016,511	15,016,511	11,419,274	10,920,782	10,415,774	11,419,274	10,920,782	10,415,774	7,282,657	21.
22.	Total	52,272,541	52,272,541	48,675,304	48,176,812	47,671,804	48,675,304	48,176,812	47,671,804	44,812,234	22.
23.											23.
23.	Increased Gas Purchases & Production Taxes:										23.
24.	Gas Royalties	3,096,196	3,195,425	2,753,654	2,701,188	2,665,368	2,296,484	2,269,020	2,153,700	1,159,273	24.
25.	Gross Production Taxes	1,072,681	1,107,059	954,006	935,830	923,420	795,620	786,104	746,152	250,659	25.
26.	Casinghead Gas	4,464,876	4,607,968	3,970,911	3,895,253	3,843,598	3,311,649	3,272,044	3,105,748	—0—	26.
27.	Dry Gas	1,612,310	—0—	—0—	—0—	—0—	—0—	—0—	—0—	—0—	27.
28.	Total	10,246,063	8,910,452	7,678,571	7,532,271	7,432,386	6,403,753	6,327,168	6,005,600	1,409,932	28.
29.											29.
29.	Return Provision for Taxes:										29.
30.	Return on Rate Base	14,595,766	15,252,787	14,274,681	14,140,945	14,005,463	11,091,265	10,987,418	10,882,215	10,442,892	30.
31.	Actual Liability for Federal Income Taxes	7,729,591	8,290,795	7,971,082	7,928,199	7,884,752	5,121,412	5,103,136	5,084,619	615,160	31.
32.	Tax Benefits	7,465,477	7,616,045	6,918,029	6,821,761	6,724,236	6,318,999	6,230,501	6,140,848	—0—	32.
33.	Total	29,790,834	31,159,627	29,163,792	28,890,905	28,614,451	22,531,676	22,321,055	22,107,682	11,058,052	33.
34.	Total Cost of Service	$ 92,309,438	$ 92,342,620	$ 85,517,667	$ 84,599,988	$ 83,718,641	$ 77,610,733	$ 76,825,035	$ 75,785,086	$ 57,280,218	34.
35.	Return & Tax Benefits as a Percentage of Rate Base	18.14%	17.99%	17.82%	17.79%	17.76%	14.52%	14.50%	14.47%	9.25%	35.

NOTES TO SCHEDULE V:
Column I shows the cost of service as presented by Phillips. Column IX shows the results obtained by the Examiner. Columns II through VIII, inclusive, show seven calculations based upon variations from Phillips' cost of service.
The increased cost of dry gas is excluded (line 27) from each of the seven calculations II through VIII. In each of these seven calculations, an amount is included (line 12) for working capital less ⅓ of actual Federal income tax liability. The amounts included at line 12 vary from one column to the next in direct proportion to the change in Federal income taxes, line 31.
The amounts for Increased Gas Purchases & Production Taxes (lines 24, 25 and 26) vary directly with the total cost of service.
At line 1 for each column is shown the rate of return on which that calculation is based. At line 3 for each column is shown the percentage of exploration costs allocated to gas. As indicated by the asterisks, the derivation of the exploration percentages for Columns III through VIII, inclusive, is explained on the attached sheets.

*The 45.2242% is the result of a computation made, but not sponsored, by Caplan during cross-examination (123:16486). Reference is also made to this computation and the 45.2242% in Phillips' Exceptions to the Examiner's Decision at page 107.

**The 41.25% is the result of correcting a basic error in the RAR method. The computations are described in Phillips' Exceptions to the Examiner's Decision, pages 114, 115, 116.

***The figure 43.25% represents the ratio of the net investment in gas producing leaseholds and corresponding intangible development costs to the total net investment in all producing leaseholds and their corresponding intangible development costs. The various exploration accounts to be allocated between oil and gas consist of leasehold costs and well drilling costs, rather than production equipment costs. Pages 15 and 16 of Exhibit 282 provide a listing of the exploration accounts which include lease rentals, expired and surrendered leases, dry holes, lease development AFE's, and drilling equipment. The ratio is developed from the record made in Docket No. G-1148, as follows:

A. Compile the total net investment (including an allocated part of general assets) in producing leaseholds and intangible development costs.

Dry Gas Leases	84.16%[1]	of $ 50,201,147[2]	or $ 42,249,285
100 % Oil Leases	58.28%[3]	of $ 46,109,957[4]	or $ 26,872,883
Joint Product Leases	58.28%[3]	of $163,420,819[4]	or $ 95,241,653
Royalties and Overriding Royalties			$ 1,230,948[5]
			$165,594,769

B. Segregate the part applicable to gas producing leases.

Dry Gas Leases	100 %	of $ 42,249,285	or $ 42,249,285
Joint Product Gas	30.838%[6]	of $ 95,241,653	or $ 29,370,621
			$ 71,619,906

C. It follows that the ratio of net investment in gas producing leaseholds and intangible development costs to total net investment in producing leaseholds and intangible development costs is $71,619,906 divided by $165,594,769, or 43.25%.

[1] Leaseholds and intangible development costs constitute 84.16% of the net investment in dry gas producing leases.

(Footnotes Continued on Next Page)

Exhibit 354, sheet 6, year 1954, Natural Gas Department.

Leaseholds	$ 9,821,399	
Intangible Development Costs	29,686,930	
	39,508,329	84.16%
Lease Equipment	7,437,618	15.84%
	$46,945,947	100.00%

[2] The total net investment in dry gas producing leases, including an allocated part of general assets, is $50,201,147 and is shown at line 11, page 17, of Exhibit 282.

[3] Leaseholds and intangible development costs constitute 58.28% of the total net investment in producing leases of the Oil and Gas Production Department.

Exhibit 354, page 6, year 1954, Oil and Gas Production Department.

Leaseholds	$ 16,859,364	
Intangible Development Costs	97,430,872	
	114,290,236	58.28%
Lease Equipment	81,821,998	41.72%
	$196,112,234	100.00%

[4] The total net investment, including an allocated part of general assets, of the Oil and Gas Production Department is shown at line 8, page 18, Exhibit 282: 100% Oil Leases $46,109,957 and Joint Product Leases, $163,420,819.

[5] The net investment in royalties and overriding royalties is $1,230,948 which comprises the four royalty items shown on page 14 of Exhibit 282.

[6] Computed in accordance with the relative cost procedure illustrated on page 11 of Exhibit 282, the percentage of Joint Product net investment in leaseholds and intangible development costs attributable to gas is 30.838%.

Computation:

$$\frac{\frac{\$\ 42,249,285}{226,681,178}\ (149,009,734)}{\frac{\$\ 42,249,285}{226,681,178}\ (149,009,734) + \frac{\$26,872,883}{13,056,309}\ (30,261,670)} = 30.838\%$$

32571

MORGAN, LEWIS & BOCKIUS
COUNSELORS AT LAW
PHILADELPHIA, PENNSYLVANIA

May 6, 1960

Federal Power Commission
Washington 25, D. C.

Re: *Phillips Petroleum Company—Docket Nos. G-1148, et al.*

Gentlemen:

This will respond to the Offer of Settlement submitted by Phillips Petroleum Company herein by letter of April 6, 1960. For reasons outlined below, the Eastern Seaboard Companies* do not find the terms of the Offer acceptable in its present form and are compelled to oppose it.

We agree with the statement set forth in the concluding sentence of the first paragraph of Phillips' letter, to the effect that "the entire natural gas industry has been operating for a long time in a state of indecision and confusion". Obviously, everyone, including the Commission, would agree that this is an undesirable situation which should be remedied with the least practicable delay. We do not agree, however, that the solution suggested by Phillips is designed to achieve the intended purpose. On the contrary, the proposal, if adopted, would do nothing but perpetuate the "state of indecision and confusion" and would negate five years of effort on the part of the Commission's Staff, Phillips and many intervenors to build a record on

* Long Island Lighting Company, Philadelphia Electric Company, Public Service Electric & Gas Company, The United Gas Improvement Company.

the basis of which meaningful regulatory principles may be established.

This Commission has said on numerous occasions that it does not believe it should use its conditioning authority under Section 7 of the Act to fix producer prices; that rates are intended to be established under the rate making sections, 4 and 5.

This is a proceeding under those sections and the record is complete, at least as to all issues involving the determination of cost of service and necessary revenue level. Complicated though the facts may be, the Examiner understood them and rendered his decision upon them; the Commission can and should do likewise, and without delay, in order that ground rules under which proceedings of this type are to be conducted may be established for and understood by the entire industry.

Phillips suggests that its cost of service amounts to $92 million but that it is willing to settle this case on the basis of its own negotiations with its purchasers for $70 million. While we are in no position without further information to evaluate the merits of this proposal in terms of net revenues to the Company,* we can say that the basis upon which it is founded is entirely unacceptable to us. While we would be willing to negotiate with Phillips at any time, with a view toward arriving at a fair and just settlement of the controversy here involved, such negotiations would have to be within the framework of the Act as it has been interpreted by the Courts. Since we do not view Phillips' proposal of April 5 as meeting that standard, however, we are unequivocally opposed to it.

* The 1960 level of which preliminary examination indicates to be far in excess of the level found by the Examiner to be reasonable.

Copies hereof have been served this date upon all parties of record.

Very truly yours,

J. DAVID MANN, JR.
J. David Mann, Jr.
Attorney for the
EASTERN SEABOARD COMPANIES

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32643

[Mimeo., p. 1]

Before Commissioners: Jerome K. Kuykendall, Chairman; Frederick Stueck and Arthur Kline

Docket No. G-1148

Docket Nos. G-3175, G-4333, G-6621, G-7773, G-8623, G-8695, G-8883, G-10359, G-10793, G-10883, G-11125, and G-11217

Opinion No. 338

Opinion and Order Determining Cost of Service and Terminating Proceedings

(Issued September 28, 1960)

This is a rate proceeding under Sections 4 and 5 of the Natural Gas Act and is a sequel to the decision of the United States Supreme Court on June 7, 1954 in *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672 which reversed the determination made by this Commission and held that we had jurisdiction over the wholesale rates in interstate commerce of the Phillips Petroleum Company even though it is an independent producer of gas and not a pipeline company. In this proceeding rates have been determined

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for Phillips by the presiding examiner in his decision issued April 6, 1959, and the issues involved are now before us after the filing of exceptions to his decision and oral argument before the Commission.

The original proceeding arose on October 28, 1948, 7 FPC 983, when we instituted an investigation under Section 5(a) of the Natural Gas Act to determine whether Phillips was a natural-gas company within the jurisdiction of the Commission and whether its rates were unjust or unreasonable. After a hearing, the Commission determined on August 16, 1951, (10 FPC 246) that Phillips was not a natural gas company, but this decision was reversed by the Court of Appeals for the District of Columbia,[1] which, in turn, was affirmed by the Supreme Court of the United States in the above mentioned decision.

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[Mimeo., p. 2]

As a result of the Court decisions, we vacated on November 22, 1954, our previous termination of the proceedings in G-1148 and reinstituted our Section 5(a) investigation of Phillips' rates. By later orders we consolidated the proceedings in Docket No. G-1148 with proceedings under Section 4(e) of the Gas Act arising out of the suspension of increased rates filed by Phillips in the other dockets listed in the title above. The increased rates proposed in these dockets became effective at various dates subject to refund.

The hearings in the consolidated proceedings commenced on June 26, 1956 and, after 82 hearing days, were closed on December 18, 1957. The parties include Phillips, the staff of the Commission and some thirty-one interveners. At the October 15, 1957 session of the hearing after the presentation of the cases of Phillips and the staff, cross-examination

[1] *State of Wisconsin* v. *F.P.C.*, 205 F. 2d 706 (CADC 1953).

thereon and the supplying by Phillips of additional data at the request of various interveners, counsel for the Wisconsin Public Service Commission moved that the examiner direct the staff to make further studies and present additional data in the record to fill alleged gaps. The examiner and subsequently the Commission denied Wisconsin's request.

On December 2, 1957, two weeks before the close of the hearing, staff counsel moved the examiner to grant a recess of six months to permit the staff to make a further investigation for the purpose of adding to the record data with respect to the cost of Phillips' joint product wells, broken down on an area basis, so as to assist the Commission in fixing rates on an area basis rather than a company-wide basis if it should desire to do so. The examiner denied this motion on the ground that the problems raised had been obvious for some time, that the additional evidence would not necessarily be sufficient, and that granting the motion would result in great delay in the completion of the proceedings. The Commission affirmed the examiner's ruling on this matter also.

Briefs were filed by Phillips, a number of interveners and the staff; and the examiner issued a decision on April 6, 1959 in which he thoroughly analyzed the questions at issue. Thereafter exceptions were filed by Phillips, Minneapolis Gas Company, San Diego Gas & Electric Company, Panhandle Eastern Pipe Line Company, Northern Natural Gas Company and Permian Basin Pipeline Company, Pacific Gas and Electric Company (P.G.&E.), Southern California Gas Company and Southern Counties Gas Company of California (Southern California Companies), Minneapolis Gas Company, Michigan-Wisconsin Pipe Line Company, El Paso Natural Gas Company, the Michigan Public Service Commission, the State of Wisconsin and the Public Service Commission of Wisconsin (Wisconsin), the Public

Utilities Commission of the State of California and the staff of this Commission. The Eastern Seaboard Companies[2] filed a statement to the effect that they didn't specifically except to any portion of the examiner's

decision but asked to participate fully in the oral argument. The Mid-Continent Oil & Gas Association moved to file a brief *amicus curiae* and a brief in which it objected to the use of the cost of service method of fixing rates for independent gas producers and urged that the present case, in which the evidence was based on cost of service, be decided in such a manner that it not be a precedent in other independent producer rate cases as to the standard for regulation or even as to the cost of service method itself, if that method should be used.

Oral argument was held before us on October 1 and 2, 1959. Representatives of Phillips, the Eastern Seaboard Companies, the California Commission, the Wisconsin Commission, several other intervenors[3] and our staff participated. The issues in this proceeding are thus before us and many questions arise. The most important question is whether the cost of service method should be applied in this proceeding. Assuming that it is necessary for us to use the cost of service method here, very important questions relate to the allocation of costs, particularly exploration costs between oil and gas, the effect of rate increases on the cost of purchased gas, the acreage to be included in the rate base, rate of return and the effect to be given to our cost of service determination on Phillips' rates.

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2 Long Island Lighting Company, Public Service Electric and Gas Company, Philadelphia Electric Company and the United Gas Improvement Company.

3 City of Detroit, Michigan-Wisconsin, P.G.&E., the Southern California Companies, Minneapolis Gas Company and San Diego Gas & Electric Company.

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[Mimeo., p. 4]

THE PHILLIPS PETROLEUM COMPANY

Phillips sells more natural gas in the United States than any other oil and gas producer; and it is the largest producer of liquids condensed from natural gas. It also engages in various phases of the oil and petro-chemical business with operations spread throughout the United States and in several foreign countries. Its operations include the exploration for and the production of oil and gas, the purchase of oil and gas from other producers, the gathering of natural gas, the processing of natural gas in gasoline plants for the extraction of liquid hydrocarbons, the refining of crude oil and other petroleum products, the manufacture and sale of various chemicals, the operation of oil pipelines, the sale of petroleum products, and research and development.

While Phillips is the largest seller of natural gas, its annual revenues from this source were but 6 percent of its total gross income in 1955. In the test year 1954, it sold 688,811,312 Mcf, of which 491,178,953 or 71.3 percent were sales for resale in interstate commerce. As the examiner notes, Phillips' natural gas operations extend from the Gulf Coast to Montana and Wyoming with the greatest concentration of sales occuring in Texas, Louisiana and Oklahoma.

Three of Phillips' departments are directly concerned with natural gas. These are the Natural Gas Department, which operates all wells producing dry gas only and all gas gathering systems, the Natural Gasoline Department, which operates the gasoline plants, and the Oil and Gas Production Department, which operates wells producing both oil and gas, including gas condensate wells. In addition, several service departments perform services in connection with natural gas operations. As a result of the operations of these departments, Phillips sells dry natural

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gas, gas-condensate well gas, raw casinghead gas in the field and from gathering systems, and residue gas at the outlet of its gasoline plants after the saleable liquids have been extracted. In the year 1954, a total of 375,690,912 Mcf was produced, 226,681,178 Mcf in the Natural Gas Department and 149,009,734 Mcf in the Production Department, and an additional 407,984,210 Mcf were purchased.[4]

32647[5]

[Mimeo., p. 5]

REGULATION OF NATURAL GAS PRODUCERS' PRICES

With the full proceedings before us involving the largest independent producer of natural gas from the standpoint of sales in interstate commerce the time has arrived when the Commission can express its views on the policies which must be followed in order to regulate the rates of independent producers of natural gas in a sane, sensible and effective manner. Heretofore, we have been confined to the record of particular cases, which generally did not afford a basis for employing the experience which we have acquired in the many cases which have come before us, including, now, this one.

Experience of the Commission in this case, as well as in many other producer rate cases during the last five years, has shown, beyond any doubt, that the traditional original cost, prudent investment rate base method of regulating utilities is not a sensible, or even a workable method of fixing the rates of independent producers of natural gas. The fact that, in this case, we can, by making numerous arbitrary allocations and estimates, arrive at a calculated unit cost of gas does not prove to anyone's satisfaction, including ours, that we have thus solved the problem of

[4] These volumes relate to the United States only. The difference between the amounts produced and purchased and the amounts sold consists of company uses, losses and return to leases, etc.

fixing prices for natural gas sold by independent producers. We recognize that the use of this method for regulating utilities provides only some possible aid toward solving, but not the answer to, the problem of fixing producers' rates.

Producers of natural gas cannot, by any stretch of the imagination, be properly classified as traditional public utilities. Justice Harlan, dissenting in the recent case of *Sunray Oil Co.* v. *F.P.C.*, 364 U.S. 137 at p. 160, characterized the difference as follows:

> ". . . A pipeline performs a service akin to those traditionally performed by public utilities. The independent producer, on the other hand, is unique among the objects of public-utility regulation because it is not engaged in rendering a service to the public in the conventional sense of that concept, but rather simply in selling a commodity which it owns. . . ."

A natural gas pipeline, under our regulation, usually has a fair opportunity to earn a fair rate of return, but such is not necessarily the case with a producer. The pipeline investor is reasonably assured of the financial feasibility of a project before any funds are expended for construction. The pipeline constructs facilities only after the issuance of a certificate of public convenience and necessity and reasonable assurance of fair rates. The producer must invest his funds prior to ascertaining whether he will have anything to sell or whether, if he does, he will have an adequate market. Thus it is clear that in regulating producers, we are faced with problems entirely different from those presented by an ordinary public utility. Furthermore, to fix rates of gas producers simply by allowing a return on investment or rate base will penalize the efficient or fortunate producer and will unduly reward the inefficient or unfortunate producer. As Justice Jackson put it in his

dissent in *F.P.C.* v. *Hope Natural Gas Co.*, 320 U.S. 591 at 649.

[Mimeo., p. 6]

> ". . . The service one renders to society in the gas business is measured by what he gets out of the ground, not by what he puts into it, and there is little more relation between the investment and the result than in a game of poker."

Virtually the only situation in which the investment would have a real relationship to the return is where the producer has purchased fully developed acreage at a current fair price. Otherwise the determination of the cost of a producers' assets upon the happening of a certain event, or at a certain point in time will produce unrealistic and inequitable results. Under the cost rate base method the producer who first takes the risk in an area and proves it productive will get the least return, for he will undoubtedly pay less for his rights than those who come in later after the area is proved.

While the examiner felt that the traditional rate base method of rate regulation could ultimately be successfully used to regulate producers' rates, we are convinced that such a method is unworkable, and will produce fallacious results. This conclusion is based not only upon our examination of the record in this case but to an even greater extent upon the knowledge and expertise we have gained from the many producer cases which we have had before us, either after an examiner's decision or upon some matter of procedure or evidence in pending cases, and from years of study of these problems.

We are not dealing with a service requiring certain equipment at known costs. We are dealing in many instances with one of two commodities produced with the same equipment and processed to varying degrees prior

to sale. The price of the second commodity, oil, is unregulated, as is that part of the gas, which is sold in intrastate commerce or other transactions not subject to our jurisdiction, as well as the products which are extracted prior to shipment. Thus we are faced with the extremely difficult problem of allocating costs between the regulated and unregulated products. The record shows that none of the experienced, diligent, and intelligent experts who have labored on this problem have proposed any allocations which were acceptable to other experts. Every method of allocation advanced was shown to have at least some element of guesswork or to ignore some facts.

While we must make allocations in all rate cases, the amounts involved in electric and gas pipeline cases have been comparatively small and the allocations relatively simple. In the case of the producer, the amounts involved in the allocations of costs are major in size and extremely difficult to make. The result is that a producer actually could become bankrupt, or could make enormous profits, depending merely on the methods of allocation used. We do not say that allocations cannot be made. We say that in this kind of case the rates should not be wholly dependent upon them.

Further experience may enable us to refine and improve our allocation methods, but it is clear that the calculation of the unit cost of gas is, and will be an inexact, complex, unsatisfactory, and time consuming process, fraught with controversy. The result finally reached may give the illusion

of accuracy since mathematical processes are involved, and a definite price per Mcf is the final result. But such a result must be tested against the realities of the market place. Thus, prices calculated solely on the cost rate base principle cannot be accepted if they are higher than a buyer will pay, or lower than a seller will accept.

When an unrealistic result is reached, the formulae for allocations must be changed, in order to bring about a reasonable result. The allocation methods then become a means of supporting a result already arrived at, rather than a means of arriving at a result which was previously unknown.

Another difficulty in determining cost of gas per unit is presented by the necessity of using estimates of reserves of gas, which can never be precise and have been shown to be highly inaccurate in many cases, with qualified experts differing as much as 100 percent over reserves in the same formations. See e.g., *El Paso Natural Gas Company*, Docket No. G-12580, 22 FPC 900, page 904 and 918, *et seq.*

The rate base cost of service method entails consideration of the tax laws applicable to percentage depletion and intangible well-drilling costs. (I.D.C.) Thus these difficult and disputatious matters, the effects of which are extremely difficult to predict, become major issues, along with the methods of allocation. Instead of simplifying, they obfuscate and hinder the solution to the problem of arriving at a just and reasonable rate for natural gas sold by a producer.

Ridiculous results will be reached among the great number of producers and owners of interests if costs should be the only basis for regulation. In unitized fields many single wells have as many as fifty part owners. If cost is to be the sole criterion, each owner would be required to show his costs. Any other course would presumptively be unlawful and confiscatory as to those owners whose costs were not shown. Under the rate base method, Phillips' new rates could not be said to be fair for co-owners. Thus from each well in the United States every Mcf of gas might have a different price tag. Gas from one well might well range in cost from 1 cent to 10 dollars per Mcf.[5]

[5] See *Pan American Petroleum Corp., et al.*, Opinion 310, 19 FPC 463.

In this connection it is to be noted that much of the gas which Phillips sells into interstate commerce is purchased from thousands of independent producers whose rates under percentage-type casinghead contracts are dependent upon Phillips' rates. We discuss this problem more completely below under the subject of Expenses. It should be pointed out at this point, however, that the percentage-type of casinghead contracts which share the proceeds of sale, give automatic rate increases for thousands of producers selling to Phillips with no possible determination by us of actual just and reasonable prices to each seller for such casinghead sales.

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[Mimeo., p. 8]

We must also consider the interests of the many royalty owners who are paid a percentage of the price received for the products. If cost is to completely control price, landowners would be well advised to lease only to the producing companies who have and can show high costs. Thus low cost producers who must replace diminishing resources would find it increasingly difficult to obtain new leases. In keeping with such a showing of higher costs we must bear in mind the fact that almost half of the markets for gas in this country are not under our jurisdiction. This gives many producers substantial room in which to manipulate their sales in order to sell only in interstate commerce the gas with the highest production costs.

In his concurring opinion in *Colorado Interstate Gas Co.* v. *F.P.C.*, 324 U.S. 581, Justice Jackson anticipated the chaos of such a situation when he stated at page 610:

> "To let rate-base figures, compiled on any of the conventional theories of rate-making, govern a rate for natural gas seems to me little better than to draw figures out of a hat. These cases confirm and strengthen me in the view I stated in the *Hope* case that the entire

rate-base method should be rejected in pricing natural gas, though it might be used to determine transportation costs. These cases vividly demonstrate the delirious results produced by the rate-base method. These orders in some instances result in three different prices for gas from the same well. The regulated company is a part owner, an unregulated company is a part owner, and the land owner has a royalty share of the production from certain wells. The regulated company buys all of the gas for its interstate business. It is allowed to pay as operating expenses an unregulated contract price for its co-owner's share and a different unregulated contract price for the royalty owner's share, but for its own share it is allowed substantially less than either. Any method of rate-making by which an identical product from a single well, going to the same consumers, has three prices depending on who owns it does not make sense to me. . . ."

Another problem inherent in regulation of producers on a cost basis is the administrative burden of having a full cost rate case for each of the thousands of independent producers. And one case per producer would not be sufficient. The uncertainty of the business assures that a great many producers will have substantial cost and revenue fluctuations from year to year and, if cost were our only criteria, the interests of both consumers and producers would require a full cost hearing repeatedly for each producer. Thus adherence to the original cost rate base method of regulation results in the necessity of a full scale, company-wide cost study of a producer in order to determine whether the price contained in any one contract represents revenue to which the company is entitled. If the Commission suspends a two mill escalation in a contract, and then processes that case in the usual manner, the same work

must be done as would be done in a Section 5(a) investigation. This is one of the main reasons why this long drawn out case must

necessarily result in the disposition of relatively few of Phillips' many filings. Certainly we cannot judge Phillips' precise revenue requirements for 1960 and the future based on its costs for 1954.

An illustration of the administrative impossibility of separate determinations for all producers' rates is found in the fact that there are 3,372 independent producers with rates on file with this Commission.[6] The producers have on file with us 11,091 rate schedules and 33,231 supplements to these schedules. Currently, 570 of these producers are involved in 3,278 producer rate increase filings now under suspension and awaiting hearings and decisions. The number of completions of independent producer rate cases per man-year during the first 6 years following the Phillips decision indicate that nearly 13 years would be required for our present staff to dispose of the 2,313 cases pending on July 1, 1960. Within this 13-year period an additional estimated 6,500 cases would have been received.

Thus, if our present staff were immediately tripled, and if all new employees would be as competent as those we now have, we would not reach a current status in our independent producer rate work until 2043 A.D.—eighty-two and one half years from now. Of course, we could expect to improve our techniques and thus shorten the time required to process these cases. If we increased our efficiency one thousand percent, we would achieve current status in 1968—eight and two-tenths years from now. And regardless of how much our staff is increased every case must still

[6] To these add 15,435 non-filing co-owners whose rights should also be considered under any rate base theory.

be reviewed by us and our own time and capacity is not unlimited.[7]

As the cost evidence in this case indicates, and as the examiner found in this case even absent sales manipulations, our function in regard to producers may well become one of permitting increases in gas prices if each producer is to be regulated solely on a cost basis. In this connection, it may be noted that at this time 11 producer rate increase cases have had full hearings and have been finally decided by us on a cost basis. In 10 of these

cases the costs showed that the proposed prices were more than justified.[8] In the other case, *H. L. Hunt*, 19 FPC 748, difficulties with an affiliated seller's rate prevented us from deciding the rates of the applicant. Three 5(a) proceedings against producers have been fully concluded and in all three the producers' prices were shown to be justified on a cost basis.[9] Phillips will add one more to this list.

Of 30 producer rate increases submitted with cost data up to this time, 16 have been accepted by our staff when a study of the data showed that the prices were more than justified even though every accounting issue was resolved against the

[7] The Bills introduced into Congress to eliminate some smaller producers from our jurisdiction would not actually reduce these figures to any substantial extent. Field unitizations, production fluctuations from year to year, fluctuations in the allowables set by the states, processing contracts and various other factors would prevent such a law from reducing our workload to any great extent beyond that which it has already been reduced by our own regulations in regard to filings.

[8] *Wunderlich Development Co.*, 15 FPC 690, *Davidor & Davidor*, 15 FPC 1236, *Christie Mitchell*, 15 FPC 751, *William Negley*, 17 FPC 550, *Bayview Oil Co.*, 21 FPC 405, *Rebstock & Reeves*, FPC , *Sinclair Oil Co.*, 22 FPC 53, *Harper Oil Co.*, 17 FPC 803; *Hassie Hunt Trust*, 21 FPC 37, *Monsanto Chemical Co.*, 22 FPC 1077.

[9] *Gillring Oil Co.*, 20 FPC 770, *Ralph E. Fair*, 20 FPC 810, *C. V. Lyman*, 22 FPC 557.

applicant. The remaining 14 increases have either been settled or are awaiting hearings because of incomplete or unacceptable cost data but not because the rates involved appeared to be wholly out of line with the costs. The indications from these and filings now being studied make it quite clear that regulation of producers on a company-by-company rate base method will in all probability result in higher consumer prices than we would otherwise have.[10] Since the cost rate base method seems almost always to produce the higher rates it appears that consumers, in most instances, will be thoroughly protected if we place more reliance on existing prices and on applicable economic principles.

In fact, rigid adherence to the rate base method will, in many cases, price the producers' gas completely out of the market. This fact is now abundantly clear: Regardless of variations in allocation methods, allowance for incentives, and other disputed factors, computations of the cost of natural gas which have been presented in the many cases before us, show that natural gas has been, in almost all instances, substantially underpriced.

Furthermore, it is clear that contracts for the sale and purchase of natural gas which were in force prior to June 7, 1954, while presumed as a matter of law to be reasonable, *Wichita Railroad & Light Co.* v. *Public Utilities Commission of Kansas*, 260 U.S. 48, are, in most cases, actually reasonable, as tested by cost rate-making principles. Thus, these old contracts provide starting points, which with relatively few exceptions are fair, or more than fair to consumers.

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[Mimeo., p. 11]

From the foregoing, it follows that effective regulation of the price of natural gas must be on some more manageable

[10] The main exception to the higher cost situation exists in the gas produced from the Panhandle-Hugoton Field in Texas, Oklahoma and Kansas, which was developed near the turn of the century and has relatively more shallow producing horizons holding tremendous reserves.

plan than the rate base method. Thus it is clear that the better method would be to establish fair prices for the gas itself and not for each individual producer. While the evidence here is sufficient to allow a determination on a mathematical basis of the revenue Phillips requires, it appears that the ultimate solution to producer regulation will be in the determination of fair prices for gas, based on reasonable financial requirements of the industry and not on the particular rate base and expenses of each natural gas company.

We are, simultaneously with the issuance of this opinion and order, promulgating a policy statement setting forth rate guidance levels for various producing areas of the country. We are thereby establishing two prices for each of these areas; (1) a price applicable to new contracts above which we will not certificate new sales without justification of the price; (2) a price pertaining to existing contracts, above which we shall suspend price escalations.

This schedule of prices is only for guidance and does not constitute any determination of just and reasonable rates and will not foreclose any person from justifying a particular rate in any area. Prices now shown on this schedule will no doubt be revised from time to time, as experience indicates they should be. Other revisions and refinements no doubt will also be made, such as changes in the boundaries of the areas, provisions for variations in physical qualities of the gas, terms of delivery, and other factors.

Our ulfimate objective will be to set prices in all producing areas which will be adequate to maintain the gas supplies needed by the consumers of the nation, but at prices that are no higher than are necessary to accomplish that purpose.

We intend to make use of cost data we have obtained in the past and we intend to acquire and consider cost information in the future. We also intend to use all information of an economic nature we have acquired, and to continue to

acquire and use such data in the future. Costs incurred in the past are only a part of the body of information pertaining to the economics of the gas producing industry which is necessary for intelligent regulation of that industry.

Costs pertaining to the representative sampling of the industry in any one area must be accepted as part of the basis for fixing rates for all producers in the area. Obviously, as we have shown previously, it is impossible as well as absurd to obtain the cost data for each and every one of the thousands of producers under our jurisdiction.

We fully realize that some persons will contend that the plan of rate regulation we here announce is not lawful and that we are bound by *City of Detroit* v. *F.P.C.*, 230 F. 2d 810 (CADC, 1956), *certiorari* denied 352 U.S. 829, to calculate a rate base and determine a rate of return, at least as a point of departure. If this contention is correct, then, as a practical matter, adequate regulation of producers appears to be impossible under existing law.

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[Mimeo., p. 12]

Nowhere in the Natural Gas Act is there as much as one word which indicates that this Commission must use a rate base in determining just and reasonable rates. The correct construction of the Natural Gas Act on this question, both as a legal and as a practical matter has been made by the Court of Appeals of the Fifth Circuit in *Forest Oil Corporation* v. *F.P.C.*, 263 F. 2nd 622 (1959), wherein the Court said:

> We do not think that either the Commission or the petitioner should be baffled or handicapped in this new field of regulation by any formulas by whatever name they are known. Specifically, if there is an accounting or rate-making formula known to the public utilities industry as a "conventional rate-base method of rate-making" which the Commission in its order of dismissal in this case said must be used at least as a basis of

> comparison or point of departure, we say the Commission need not require it unless such method is the only way by which the Commission can make its required determination. . . . (263 F. 2d 622, 626).

In dealing with the competitive industries such agencies as the Interstate Commerce Commission have found it best to work out regulatory principles based on numerous other standards and criteria. Producer regulation will have to be based on similar considerations. As Justice Jackson stated in his concurring opinion in *Colorado Interstate, supra,* at p. 612:

> ". . . Far-sighted gas-rate regulation will concern itself with the present and the future, rather than with the past, as the rate-base formula does. It will take account of conditions and trends at the source of the supply being regulated. It will use price as a tool to bring goods to the market—to obtain for the public service the needed amount of gas. Once a price is reached that will do that, there is no legal or economic reason to go higher; and any rate above one that will perform this function is unwarranted. If the supply comes from a region where there is such overproduction that owners are ready to sell for less than a fair return on their investment, there is no reason why the public should pay more. On the other hand, if the supply is not too plentiful and the price is not a sufficient incentive to exploit it and fails to bring forth the quantity needed, the price is unwisely low, even if it does square perfectly with somebody's idea of return on a 'rate-base'. The problem, of course, is to know what price level will be adequate to perform this economic function. . . ."

And as the same justice concluded in the *Hope* case, *supra* at page 650:

". . . If natural gas rates are intelligently to be regulated we must fit our legal principles to the economy of the industry and not try to fit the industry to our books. . . .

We realize that any decision we make in this and similar cases will be subjected to the lengthy processes of court review. However, in the absence of the appropriate congressional legislation the resultant delay and uncertainty is an unavoidable hazard.

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[Mimeo., p. 13]

REGULATION OF PHILLIPS' PRICES

While we have found that the rate base method is not an effective means of regulating the producers' prices, evidence in this proceeding was presented almost entirely upon the cost basis and, of course, there were no ceiling prices issued by us at the time of the hearing. There was some field price evidence introduced, but if field prices could be employed in arriving at rates for Phillips, the evidence was incomplete and unrepresentative of Phillips' diverse sales. Therefore we shall proceed on the basis of the evidence adduced in this case to reach conclusions, as reasonable, intelligent and logical as possible even though we know and have herein stated the difficulties inherent in determining a cost of service for Phillips using the rate method. This is clearly a lawful way to determine rates for Phillips as illustrated by the *City of Detroit* case,[11] and under the present record is the only possible method, and therefore we shall make every effort to reach a result by this means.

As will be seen from the discussion below of Phillips' cost of service, the difficulties of the rate base method as

[11] *City of Detroit* v. *F.P.C.*, 230 F. 2d 810 (CADC), *certiorari* denied, 352 U.S. 829.

applied to independent producers are well illustrated. In a number of instances, particularly with respect to allocations and rate of return, it is extremely difficult to arrive at a reasonable result by any formula or systematic method. A number of factors must be taken into account and a decision must be made without any possibility of precisely weighing the factors although we have the record before us and a general knowledge of the gas producing industry. In reaching our decision on the various points, we are of the opinion that it is perfectly proper for us to consider the complicated factors involved and reach a result on the basis of our discretion and judgment—in fact, there was no other way to proceed—but we think that many times repeated application of these judgment factors to the thousands of producers would not be practical or expeditious regulation, as we have explained at length above. In the present proceeding we are as a matter of law permitted to reach results by this method.

"The process of rate making is essentially empiric. The stuff of the process is fluid and changing—the resultant of factors that must be valued as well as weighed." [12] "Problems may arise . . . which must be solved despite the absence of a relevant general rule. Or the agency may not have had sufficient experience with a particular problem to warrant rigidifying its tentative judgment into a hard and fast rule. Or the problem may be so specialized and varying in nature as to be impossible of capture within the boundaries of a general rule. In those situations, the agency must retain power to deal with the problems on a case-to-case basis if the administrative process is to be effective." [13] "Judgment upon—conflicting engineering and

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[12] *Board of Trade* v. *United States*, 314 U.S. 534, 546.

[13] *S.E.C.* v. *Chenery Corp.*, 332 U.S. 194, 202-203.

economic issues is precisely that which the Commission exists to determine."[14] The Commission may, in fact, form "it's own conclusion without the aid of expert opinions."[15] The problem of the allocation of costs, like the problem of the allocation of service "calls for judgment within the Commission's peculiar and expert competence."[16] When the decision "is the product of administrative experience, appreciation of the complexities of the problem, realization of the statutory policies, and responsible treatment of the uncontested facts", it "is the type of judgment which administrative agencies are best equipped to make and which justifies the use of the administrative process" and it is "an allowable judgment" which the Court "cannot disturb."[17]

Upon arriving at a cost of service based upon the facts in the record and our judgment applied to these facts, we are then faced with the problem of rates. As will be set forth below, we do not think that it is appropriate to set rates for the future on the basis of this record in this hearing that terminated December 18, 1957, utilizing a test year of 1954 or 1956 and are therefore terminating the proceedings under Section 5(a) in Docket No. G-1148, particularly since rates for the future will be subject to the area price standards we are announcing. Since we are finding that Phillips' cost of service on the basis of the test year 1954 exceeds its jurisdictional revenues, and on the basis of other considerations discussed below we are also terminating proceedings under Section 4(e) consolidated herewith.[18]

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[14] *Chapman* v. *F.P.C.*, 345 U.S. 153, 171.

[15] *Market Street R. Co.* v. *Comm'n.*, 324 U.S. 548, 560.

[16] *Michigan Consolidated Gas Co.* v. *F.P.C.*, 203 F. 2d 895 (CA3).

[17] *S.E.C.* v. *Chenery Corp.*, *supra* 332 U.S. at p. 209.

[18] Two of these proceedings, however, will be left pending until the rates of Phillips' customers are finally determined as explained below.

(32656)

We can now turn to the discussion of Phillips' cost of service. Before examining the various items in controversy we may say that we agree with the examiner that 1954 is an appropriate test year for the purposes we have in mind. Phillips had submitted a cost of service study for 1956 which indicated that its jurisdictional cost of service for that year was not very different from 1954. The Southern California Companies contended, however, that Phillips' earnings in 1954, and in 1956 were unrepresentatively low and had requested that a cost of study be submitted on the basis of 1955 operations. The testimony shows that Phillips' higher earnings in 1955 were essentially from operations other than the production of oil, gasoline, and gas. Under these conditions, there would have been little utility in requiring that Phillips submit a third cost of service study, so we shall use 1954 as a test year.

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[Mimeo., p. 15]

EXPENSES

Expenses, except for allocation and tax questions, have not given rise to many controverted issues in this proceeding. We shall defer consideration of the total tax and the tax benefits arising from the statutory tax incentives relating to percentage depletion and I.D.C. until we discuss rate of return. Other expense issues relate to the size of oil and gas exploration expenses, the alleged increase in purchased gas costs, and treatment of certain interest deductions for tax purposes.

As set forth by the examiner, Phillips' total exploration and development expenses for gas and oil, before adding return, amount to $47,474,039. (See Appendix 1). There are included expenses relating to underdeveloped lease rentals, drilling tools, expired and surrendered leases, dry holes and land and geological activities. Return and taxes as computed herein would amount to $10,839,194, making a total

exploration cost of $58,313,233. The Southern California Companies and P.G.&E. contend in their exceptions that Phillips has not met its burden of proof merely by reciting the amount of its exploration expenses during the test year and that such amounts should not be accepted uncritically. The Southern California Companies present figures to show that Phillips' gas reserves have been increasing, that the claimed exploration expenses in the test year 1954 were the highest to that date and that there has been for more than a decade a substantial excess of reserves added over gas produced. They do not object to imposing upon current production, some reasonable portion of current exploration expenditures, but believe that an inquiry should be made as to the extent of the exploration expenditures that should properly be borne by current production. Neither of these parties offers any theory or any criteria for determining how much of the exploration expenses should be included in the cost of service for the test year.

In view of the increasing needs for gas and the increasing costs of obtaining it as shown by the record in this case, we are of the opinion that Phillips' overall exploration costs are reasonable. It is true that Phillips is developing gas reserves at a greater rate than it is producing gas, but the record shows, and it is well known to us, that there is an expanding demand for natural gas. Therefore it is reasonable and prudent for Phillips to develop more reserves each year than it produces. We are of the opinion that Phillips has not shown an excessive tendency in this direction, particularly in view of our treatment of the expenses related to the San Juan reserves sold in place after the test year and are therefore disposed to allow expenses undertaken in the discretion of management to obtain for Phillips adequate reserves to continue its business. It will be noted below that exploration expenses allocated to gas, amount to 3.5 cents per Mcf, which appears to be in line with industry practice.

With respect to purchased gas, Phillips argues that if it is allowed increased rates, its cost of gas will rise automatically under percentage-type casinghead gas contracts with its suppliers, so that it should be

[Mimeo., p. 16]

allowed an anticipated increase in the cost of purchased gas. In the cost of service submitted by Phillips, this particular item would amount to $8,183,917; as the examiner computed a lower cost of service and consequently lower rates, the same item, if it had been allowed by the examiner, would amount to $1,671,733, as computed by Phillips. The examiner was of the opinion that the purchased gas cost adjustment should not be allowed, for no showing had been made that Phillips' suppliers were entitled to an increase. We think, however, that Phillips' exception should be allowed on this point.

The producer of gas selling to Phillips under percentage-type casinghead contracts receives compensation, at least in part, on the basis of a percentage of the proceeds received by Phillips for the gas and extracted liquids sold from its gasoline plants. In other words, the producer's compensation will be measured not by the amount per Mcf of gas, but by a percentage of what Phillips receives, and the rate is fixed by formula rather than so many cents per Mcf. Although Phillips will pay more per Mcf for its purchased gas, if its own revenues from gas sold from its gasoline plants are increased, there is no change in the percentage and there is no rate change on the part of Phillips' suppliers, for which a rate schedule filing must be made. As Phillips points out, conditions other than a change in Phillips' rates could affect the amount that Phillips pays. For instance, variations in the volumes of gas sold to different purchasers may affect the weighted average price per Mcf paid by Phillips, yet it would be unreasonable to consider this a change in rate.

Our regulations recognize the percentage arrangement and do not contemplate that a change in the amount paid the producer, as opposed to the percentage, will require a rate filing. In any case, the producer under such a contract is not privileged to make a rate filing. Under Section 154.91(e), as amended by our Order 190, 21 F.R. 7616, October 4, 1956, where a producer, under a percentage contract, sells gas to the operator of a processing plant, the operator shall make all filings required to cover the sale, including a "list of the producers from whom the natural gas is purchased, showing the percentum of the resale price received by each from such sale of gas." The producer may not file rate schedules or rate changes whether or not filings by the operator have been made. The regulation notes, however, that the producer is "fully subject to applicable provisions of the Natural Gas Act, including sections 5 and 7(b)."

The purpose of this regulation is to avoid multiple rate filings by many producers selling gas to the plant operators, for there would be thousands of contracts involved in the case of a large operator, like Phillips. Such a large number of filings would make the administrative task of regulating the independent producers almost impossible. Our authority to alleviate a similar situation by regulation was upheld in *Sun Oil Co.* v. *F.P.C.*, 256 F. 2d 233 (CA5), *certiorari* denied, 358 U.S. 872. In that case Sun owned a part interest in certain gas producing units in Texas, but was not a signatory to the contract by which the gas was sold. Sun made certain

rate schedule filings but the Commission rescinded or rejected these in accordance with Section 154.91 of the regulations. The court noted the burden that would result from an unmanageable mass of rate schedule filings, and held that the rule making power of the Commission was ample to carry out the provisions of the Act, that no injury had

been shown, and that the sale by the operator under the operating agreement would be treated as a single jurisdictional sale of the unit or leasehold gas production. The present situation arising under the percentage contracts differs somewhat in that no actual sale appears to be made to the operator entrusted with the task of filing the rate schedules, but our regulation dealing with percentage contracts likewise deals with a situation that would otherwise create an administrative burden. Since the producers selling gas to Phillips under percentage contracts will receive more for their gas as a result of changes we make in Phillips' rates without a rate filing, or other action on their part, Phillips will automatically be required to pay more for its gas, and its purchased gas cost must be adjusted accordingly. It may be noted that we are not allowing any increased purchased gas cost as a result of so-called spiral escalation clauses in the contracts of Phillips' suppliers. An increase under such a contract would constitute a change in rate on the part of the supplying producer affected.

It is not possible upon the present record to determine the amount of the purchased gas cost adjustment, for it will depend upon the precise rates in effect for Phillips in the various areas. It is not necessary to make the adjustment for the purposes of this proceeding because we are not determining Phillips' rates for the future and are terminating its Section 4(e) proceedings except for two proceedings left pending for a limited purpose.

Coming to the question of the adjustment for interest deductions for tax purposes, we see that Phillips' actual recorded company-wide interest expenses for 1954 amounted to $9,892,308, but that in computing its income tax allowance, Phillips used an interest deduction of only $5,743,077. Phillips argues that this downward adjustment was justified on the ground that the difference of $6,149,231 represented interest paid in 1954 on an issue of bonds which was

converted to common stock by the end of 1955. Phillips says that without this adjustment, the provision for Federal income taxes in 1954 is understated and therefore unrepresentative. We agree with Phillips on this point.

Ordinarily, of course, we use the actual test year as a basis for determining cost of service, but we make adjustments for known changes occurring after the end of the test year. *Mississippi River Fuel Corp.*, 11 FPC 288, 291, 306; *El Paso Natural Gas Company*, 22 FPC 260, 263, remanded on other grounds as *El Paso Natural Gas Co.* v. *F.P.C.*, 281 F. 2d 567 (5th Cir. 1960). The examiner attempts to show that actual interest expense and the debt ratio for 1954 were not abnormal compared with the years both before and after. Interest expense in 1953 was $8,151,028,

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[Mimeo., p. 18]

$9,892,308 in 1954, $8,069,506 in 1955 and $6,782,565 in 1956, while the debt ratio was 22.4 percent in 1952, 28.6 percent in 1953, 27.7 percent in 1954, 11.6 percent in 1955 and 20.5 percent in 1956. It appears to us from these very figures that interest expense and debt ratio were on the high side in 1954 compared with other years. The issuance of additional debt after 1954 is related to additional assets on which an additional return would be earned, but is not relevant to the test year and must be disregarded. On the other hand, the debt associated with the 1954 assets and rate base was reduced substantially soon after the end of the test year. Thus the downward adjustment of the 1954 interest expense becomes proper in order to normalize the test year. The amount to be deducted would be $1,895,730 when allocated to the Natural Gas Department and the Oil and Gas Production Department on the basis of dollars of consolidated net assets as shown in Appendix 2.

[Mimeo., p. 19]

ALLOCATION OF PRODUCTION COSTS BETWEEN OIL AND GAS

Phillips produces gas alone on certain leases, oil alone on other leases, and both together on still other leases. The purely gas leases are operated by its Natural Gas Department; the oil only and joint products leases are operated by its Oil and Gas Production Department. The determination of the production costs, other than exploration costs, of the dry gas in the Natural Gas Department is, in the case of Phillips, relatively simple; the determination of production costs of gas produced with oil and condensate in the Production Department involves a number of most perplexing problems. For the purpose of allocating joint production costs (exclusive of exploration costs), amounting in all to $65,252,443 including return and tax incentives as set forth in appendix 5, between oil and gas produced from the same wells, a method known as the relative cost method was employed by witnesses for Phillips, the Eastern Companies, and by Wisconsin and was adopted by the examiner. This method allocates the actual costs of joint oil and gas production in proportion to the known costs of producing each product separately. The staff, on the other hand, used an imputed cost method, supported by a sales realization method, but this was rejected by the examiner.

We agree with the examiner that the imputed cost method does not constitute a satisfactory basis for the determination of the cost of Phillips' casinghead and condensate gas produced in the Oil and Gas Production Department. The imputed cost method does not allocate Phillips' total costs. It merely assumes that the unit cost of the casinghead and condensate gas is the same as the unit cost derived from dry gas produced in the Panhandle-Hugoton Field without using or reflecting the actual total costs of the joint product

wells. Furthermore, it appears that the dry gas costs in the shallow Panhandle and Hugoton fields were the lowest gas production costs on the Phillips System.

As the examiner states, the relative cost method is particularly suitable for allocating the joint production costs of a company such as Phillips where the number of leases and the geographical spread of operations provide a broad base for determining the unit costs of the separate products exclusive of exploration. Under the relative cost method a unit cost for dry gas is determined from the records of Phillips' Natural Gas Department; a unit cost for oil is obtained from the records of Phillips' Production Department relating to 100 percent oil leases and as a result of the allocation of indirect expenses between the 100 percent oil leases and the joint product leases. These unit costs for the two products are multiplied by the volumes of oil and gas produced on the joint product leases. This provides a tentative total relative cost for the oil and gas produced from such leases and a ratio of tentative gas cost to tentative total cost. This ratio is then applied to the total cost of the joint product leases to obtain the cost of the jointly produced gas. (See Appendix 5)

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[Mimeo., p. 20]

In applying the relative cost method, Phillips divided production costs into: (1) direct expenses, including depletion, depreciation, and amortization which are shown in the records by leases, (2) indirect expenses, which must be allocated to leases and (3) return and taxes, based on investment identifiable by leases. This classification appears to be appropriate and we have utilized it in the computations set forth in Appendix 5. The indirect expenses amounting in all to $20,106,343 may properly be divided into *direct general expense* and *indirect overhead*.[19] The *direct general expense*

[19] The examiner uses the term general company overhead for this item (Mimeo, p. 49).

item includes expenses as salaries of management, thrift plan expense related to the salaries, employee's retirement and insurance expenses, vacation expense and bad debt expense. These expenses relate principally to the Oil and Gas Production Department, but also to the Natural Gas Department, gathering system and gasoline facilities, and the residue gas system (see Appendix 1). The examiner included with *direct general expense* relating to the Oil and Gas Department, such items as developmental dry hole expense, lease rental expense, expired and surrendered leases and certain developmental land and geological expense to form an item called departmental general expense of the Oil and Gas Department which he allocated between the 100 percent oil leases and the joint product leases in that department. We are of the opinion that all exploration and development items are so closely related that they should be allocated together and apart from the production expenses with which we are concerned here. It is often a difficult matter to separate developmental expenditures from purely exploration expenses. For instance, it is not always possible to tell whether a well is drilled to develop an established field or to discover a new source of gas or oil, and many dry wells are drilled in areas where oil has been proven. All wells are, in a sense, exploratory.

The *indirect overhead* consists of Phillips' top-level company-wide management expenses, such as salaries and related items. It is actually composed of expenses similar to those found in direct general expense but at a higher level in the corporate hierarchy.

Turning to the method of allocation, we find that Phillips allocated the *indirect overhead* by first determining the portion of this item to be assigned to the Natural Gas Department and the Oil and Gas Production Department on the basis of net capital employed. There was no dispute about this method and we shall employ it here as set forth in

Appendix 1. Phillips then distributed the portion allocated to the Oil and Gas Department between the 100 percent oil leases and the joint product leases on the basis of net investment, and the examiner acquiesced in this method for the indirect overhead. This step was necessary, as indicated above, in order to separate those costs dealing with oil and to obtain a unit cost for oil which could be used to determine the separate oil and gas costs of the joint product leases.

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[Mimeo., p. 21]

We, however, are of the opinion that the distribution should have been made on the basis of direct operating expenses.[20] Management's function is concerned with the direct operation of the business in any particular year. It is concerned with all expenditures, not just with investment. No relationship has been shown between investment in the property and the amount of time spent by management in supervising the various activities of the company.

A similiar problem arises with respect to the distribution of the *direct general expense* of the Oil and Gas Department as discussed at some length by the examiner. This item, as stated above, also consists largely of salaries, and should properly be distributed between the 100 percent oil leases and the joint product leases on the basis of direct operating expenses. In allocating this item along with developmental dry hole expense as "departmental general expense" the examiner employed the gross investment method while Phillips, in its exceptions, said he should have used the net investment method. Since the items relating to lease investment have been transferred to exploration and develop-

[20] Actually the difference between the two methods is relatiely insignificant in result. Phillips allocates the $7,622,773 of Oil and Gas Department indirect overhead $1,675,853 to the 100 percent oil leases and $5,946,920 to the joint product leases while our distribution of the same amount is $2,385,318 to the 100 percent oil leases and $5,237,455 to the joint product leases.

ment expense and allocated as such, the principal basis of employing an investment method, either net or gross, has disappeared, and the allocation of the management items should be carried out on the basis of direct operating expenses.

In applying the relative cost method to allocate the joint production costs the question arises whether a credit should be given to gas for its use in lifting the oil. Testimony in the record showed that gas enables the recovery of a greater amount of oil from a pool than would otherwise be possible. It does this by reducing surface tension, viscosity, and specific gravity and by providing a source of energy which moves the oil through the formation to the well bore and thence to the surface of the ground. Phillips presented evidence that only the gas content up to 300 cubic feet per barrel of oil contributes to the recovery of oil. The record does not finally resolve this question nor does it provide a way of computing the credit for any supposed lifting effect of the gas. In fact, we think that it would be almost impossible to compute the value of the lifting effect of gas in oil production. Furthermore, it can be said that the lifting effect of gas is not so much a reason to give a credit to gas, but reason to increase the value of gas for lifting oil is a very valuable use for gas.

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[Mimeo., p. 22]

As Phillips points out, the 100 percent oil leases, which do not have the benefit of the gas lift, appear to represent a higher unit cost of oil production than the joint product leases, while dry gas leases represent a lower cost of gas production than the joint product leases. Thus when the relative cost method is applied to Phillips, this factor tends to shift costs to oil compensating the gas for the lifting effect, if present. Therefore, we do not see any necessity in this proceeding in crediting gas costs with a possible serv-

ice to oil production, particularly in view of the inadequacy of the record.

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[Mimeo., p. 23]

ALLOCATION OF EXPLORATION COSTS

Like independent producers generally Phillips incurs substantial costs for exploration and development for the purpose of maintaining its oil and gas reserves. These exploration and development costs are not directly associated with successful wells whose costs are accounted for as investment and in this proceeding are included in the rate base;[21] these costs do include the costs of unsuccessful exploration and, under the practices of the industry, are included in current expenses. There is no dispute as to the necessity for including an allowance for such costs in Phillips' cost of service, but there is considerable dispute as to their allocation between oil and gas.

Total exploration and development expenses before return amount to $47,474,039 and return and taxes on exploration investment as computed herein amounts to $10,839,194, making total exploration costs of $58,313,233 as discussed above and as set forth in Appendices 1 and 7.[22] The problem before us is how to divide these exploration costs between the production of gas on the one hand and oil on the other.[23] While a portion of the exploration costs can be attributed

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[21] Intangible well drilling and development costs are expensed for tax purposes as discussed below.

[22] As explained above, page 20, the examiner included as departmental general expense of the Oil and Gas Production Department, certain developmental dry hole expense ($4,521,943), lease rental expense ($163,716), expired and surrendered leases ($24,750) and developmental land, geological and geophysical expense ($1,699,037) but we combine them with the similar costs of the Natural Gas Department in exploration costs and allocate the combined amounts.

[23] Gas in this section includes vapors subsequently removed as liquids in gasoline plants; the allocation of cost between dry gas and extracted liquids is discussed in the following section.

directly to Phillips' Natural Gas Department and were so recorded, the greater part are joint costs for which some technique of allocation is necessary. We feel, as explained below, that it is appropriate and in the public interest that we deal with the allocation of Phillips' test year exploration costs as an allocation of joint costs between co-products with each required to bear its proper share of the joint costs in the light of all of the circumstances that affect the incurrence of the joint costs.

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[Mimeo., p. 24]

Ideally we would like to find some characteristic of gas on the one hand and oil on the other that would provide a simple and logical basis for allocating Phillip's exploration costs. No such characteristic has been shown to us, nor have we been able to discover any such characteristic of the respective products or any one method of allocation which will satisfactorily form a basis of allocation. What we are striving to do is to reflect not only the market demand for the two products, and the amount of physical material acquired, but also the trend of economic events by which there now appears to be a market glut for oil, but a continuous and expanding demand for gas. As a guide to final judgment it is extremely useful to examine the various methods of allocation presented in this proceeding and the results reached.

We find that Phillips, itself, employed what may be termed net leasehold investment—Btu method. By this method Phillips proposed, first to divide exploration costs between its Natural Gas Department and its Oil and Gas Production Department in proportion to net investment in producing leaseholds. Of the amounts so allocated to departments, a portion was first allocated to royalties owned by Phillips, in the amount of $2,393,368, using the same basis. Then costs were allocated between oil and gas in the Production Department in proportion to test year Btu pro-

duction of each product.[24] The exploration costs allocated to gas in the Natural Gas Department were added to the amount allocated to gas in the Production Department. Under this method, on the basis of Phillip's computation, 61.88 percent of exploration costs were allocated to gas. Phillips argued that the net leasehold investment method would reflect its experience and the fact that exploration is basically a search for reserves, and supports the Btu approach by saying that oil and gas exploration is a search for energy.

The Btu method undoubtedly has some justification and considerable appeal because of its simplicity and convenience. Exploration operations are frequently undertaken without clear knowledge of whether gas or oil, or both, will be found. Thus when either or both of these products are found it is difficult to ascribe the purpose of the exploration wholly to the respective market values of the products, so that there is considerable logic in comparing the products upon the basis of a common physical characteristic. On the other hand, such a method reflects only in part the potentialities of the hydrocarbon products. Oil and gas are not produced, purchased and used merely on the basis of Btu content or available energy. The transportation, refining, distribution and utilization factors are equal to or greater than the factors of exploration and development. As the examiner explains, the chief function of the oil industry is to provide fuel for transportation. Oil and its component, gasoline, are basically useful because they provide energy in compact, mobile and easily controlled liquid form.

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[Mimeo., p. 25]

Actually, the heavier the crude oil, the higher will be its Btu content but the lower will be its gasoline content and

[24] A Btu (British Thermal Unit) measures the heating value of the product. It is the amount of heat required to raise one pound of water one degree fahrenheit.

its price. Gas, on the other hand does not have the mobility of oil, for it must be carried in pipelines under pressure and used under limited conditions. Both oil and gas are used for the manufacture of chemicals and plastics which could not be properly compared on the basis of Btu. Thus if the Btu method is to be made practicable and useful for the allocation of costs it must be modified by the exercise of judgment based on the facts and the principles that guide producers in the incurrence of costs. Such a modification is carried out below.

The Eastern Companies advocated a method of allocation known as the "Reserves Added Realization Method" (RAR). Under this method, exploration costs were allocated on the basis of the ratio of the reserves of natural gas and natural gas liquids retained by Phillips to the present value of all additions to reserves of all products during the selected base period, whether sold or retained. The method thus makes an automatic adjustment for the large amount of reserves in the San Juan Basin sold to Pacific Northwest Pipeline Corporation in 1955. In applying this method which was adopted with certain modifications in the computation by the examiner, the Eastern Companies used the base period of 1951-1955 and a price for natural gas of 13.47 cents per Mcf, which represented the weighted average price paid by interstate pipelines for gas delivered in 1956 under new contracts in the Panhandle-Hugoton, West Texas, Permian Basin and Gulf Coast areas. For natural gas liquids they used Phillips' 1956 average sales realization of $1.587 per barrel and for crude oil and condensate the first half of 1957 average mid-continent price quotation of $3.07 per barrel. On the theory that the deliveries form these reserves would be made over an extended period, they applied an escalation of two cents every five years for the gas and a discount period of 20 years for the gas and 10 years for the oil at a discount rate of 6 percent. The exam-

iner adopted this computation of escalation and discount. The result of this method, as employed by the Eastern Companies and the examiner, is to allocate 30.46 percent of the exploration costs to gas.

RAR has the advantage of basing the allocation on the objective of exploration, that is the reserves acquired, and arrives at a result which, as will be seen, lies between the extremes represented by other methods and does not appear unreasonable, but it has severe disadvantages. Thus RAR results in the unregulated prices of natural gas liquids and oil influencing our determination of the cost of gas and therefore the rate which we would allow for gas. RAR is dependent on market prices; as regulation of the producers proceeds, the use of RAR in future proceedings would be dependent in part on regulated prices that will be used in part to determine regulated prices. RAR is rooted in the theory that there is an association of unsuccessful exploration costs with the result of successful drilling during a given period, but this is inconsistent with the accounting for exploratory losses and costs as current items and could yield unreasonable results over a limited period. Furthermore, RAR has a

very serious administrative disadvantages in that it is very difficult to estimate the size of the gas and oil reserves of a producer. Experience has shown that experts differ substantially as to the size and deliverability of the reserves. furthermore, the estimates are inherently subject to periodic change as a result of experience with the lease or field involved. Therefore, we are of the opinion that while the results may not be substantially unreasonable in this case, RAR is not a satisfactory or workable method of allocating exploration costs.

The witness for the Eastern Companies among other methods, also computed an allocation of exploration costs to gas on the basis of sales realization. This means that the allocation would be made on the basis of the revenues from the respective products during the test period. The result of this method would be to allocate 20.7 percent of allocation costs to gas and 79.2 percent to oil. When the sale of reserves is considered, 16.9 percent of exploration costs would be assigned to gas, 64.5 percent to oil and 18.6 to the sale of reserves. The sales realization method has the advantage of reflecting the market demand for the products, an important factor to be taken into consideration. It is, of course, subject to the same disadvantages as RAR in its dependence on unregulated prices for oil and natural gas liquids, and, in the case of future proceedings, in its dependence in part on regulated prices.

Several other methods of allocation presented in these proceedings depend in part on the sales realization method. The successful wells method, presented by witness for Southern, divides the cost of the dry holes between oil and gas in the same proportion as Phillips' successful wells. In employing this method, it was necessary to use sales realization to allocate the joint-product wells. The result of this method was to allocate 25.8 percent of exploration costs to gas. We agree with the examiner that the method is founded on a mythical ratio which reflects merely the relative number of dry holes placed in the gas or oil categories and neglects other factors. The method advocated by Consolidated Edison divides exploration costs between Phillips' departments on the basis of depletion expense followed by use of a conventional sales realization method based on gross revenue data to allocate Production Department exploration costs between oil and gas. The Pacific Companies employed a net contribution to earnings method which was based upon net revenues determined, in

part, by the sales realization method, and resulted in allocating 23.98 percent of the exploration costs to gas.

The witness for Wisconsin employed a net revenue method. He first determined gross revenues to be used for each of the categories of crude oil, oil from joint-product leases, gas from joint-product leases, dry gas, royalties owned operations, and cycling operations. For his gross revenue figure for gas he employed the ultimate total cost-of-service which he computed for that product. From such gross revenues he deducted total operating costs for each category and made his allocation on the basis of the net revenue figures. In order to carry out this method, it was thus

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[Mimeo., p. 27]

necessary to use the final result in order to perform an intermediate step, the allocation of exploration costs. The testimony indicated that this would involve complicated computations which were not set forth in the record. This method, which allocated 20.8 percent of exploration costs to gas, appears to us to be circular, unduly complicated and not supported by the record.

As can be seen, there is some merit to each of the allocation methods advanced by the parties, but they all have their defects. At one end of the scale can be found the sales realization methods with their emphasis on market and at the other end the Btu method with its attempt to equate oil and gas from the physical standpoint and to avoid the effect of market swings in price, particularly the price of an unregulated product. In view of the advantages of the various methods we are unable to arrive at a rigid formula for the allocation of exploration costs, nor do we think it would be desirable to do so. The relationship of gas prices and oil prices, the relationship of gas to oil in the corporate economy and other factors will differ from case to case, so that

an equitable allocation must vary in order to reflect the place that gas and oil hold in each producer's exploration program.

In making this allocation, we are confronted with the fact that substantial exploration expenditures must be generated through current revenues in order that oil and gas reserves can be discovered in sufficient volumes to maintain service and economic stability of the industry. In other words, the gas consumer must pay rates sufficient, among other things, not only to amortize the cost of the successful past drilling which makes present service possible, but also the current losses and other expenditures incurred in an attempt to replace the gas currently being produced and consumed and continue service in the future. This objective is important socially and militates against a formula for the allocation of exploration costs. However, we are not entirely without the guidance provided by the fuel value of the various products, market factors and economic trends.

None of the parties challenge the fundamental fact that it is the Btu content of fuels that makes them useful to consumers. The argument has been in regard to the importance to be accorded such energy contents of oil and gas in regard to the allocation of their joint exploration costs, and conversely what importance should be accorded the economic factors that producers consider in incurring such costs, and which affect the sale of oil and gas in the fields in different fashions. It is well known in the producing industry that it frequently is impossible to predict whether gas or oil will be found, although certain areas are more favorable for finding gas and other areas more favorable for finding crude oil. To this extent exploration cannot be entirely responsive to market price and it becomes reasonable to allocate the cost of the operation on a physical basis. On the other hand, exploratory activities are directed to obtaining saleable products so that it seems reasonable that market relationships

should also be reflected in the allocation. Furthermore, developmental activities are directed towards the production of known reserves and such activities would reflect market conditions. We must also take into

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[Mimeo., p. 28]

account that there is a continuous and expanding demand for gas while the market for domestic produced crude oil and its components is also growing, but at a slower rate.

Historically, much of the jointly produced casinghead gas was produced as a waste by-product from the production of crude oil, and no avoidable costs were incurred either for its exploration or production. Later, with improvements in conservation, gathering and processing costs became justifield to save the gas for field uses and these were considered the only costs chargeable to this gas. Now with a growing appreciation of this gas as a fuel supply for distant consumers, it is considered a co-product of crude oil in exploration as well as production. Much of such gas production now serves first as an aid to recover additional oil and gas liquids and after this, becomes available to distant gas consumers for the same uses as naturally dry gas. The output of this gas has mounted with the output of crude oil. This type of gas has, therefore, now become an integral part both of the producers joint exploration and production activities and contributes substantially to the total gas supply.

Deeper drilling in recent years has also discovered increasing proportions of gas to liquids. The contents of some of the recently developed gas-condensate reservoirs exist wholly in the gas phase; and a portion of the gas condenses naturally during the production process into a liquid that is separated and sold as light crude oil. In such instances, conservation of these liquids has sometimes required that after recovering the liquids from the gas, some or all of the gas be cycled or returned to the reservoir temporarily to main-

tain the reservoir pressure, and prevent condensation and loss of the liquids in the reservoir. In areas where these types of reservoirs are likely to occur, equal consideration is given to both products in conducting exploration as well as recovery. Phillips has also shown that over a period of years this changing pattern of production and conservation has entailed increases in the joint production investment costs per unit of output.

Because of the industry tendencies that have developed, we deem it appropriate that in allocating the joint exploratory costs and development losses of Phillips, we shall give increased consideration to the Btu's in gas as a fuel as compared with oil and not confine ourselves entirely to a relationship based solely on recent historical relative values or relative production costs. The allocation method adopted, must also encourage the exploration and development of gas as compared with oil. Furthermore, we must take into consideration that the demand for gas is increasing at a more rapid rate than that for oil, and exploration and development activities are planned and costs must be incurred some time ahead of actual production.

In dealing with exploration costs, it is appropriate that the changing outputs of each product should bear the changing exploration costs in proportion to the contribution that such costs make to each supply, and it

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[Mimeo., p. 29]

is necessary for currently produced gas to bear an increased proportion of the joint exploration costs and development leases if the growing gas demands are to be supplied on a continuing basis. Our purpose, as in past proceedings, is to require that each class of customers bear its proper share of

the cost.[25] Furthermore, in this proceeding we have the particular problem, apart from the traditional methods of allocation based upon past experience, of providing Phillips with sufficient funds for future exploration and production. This is a problem whose solution must depend not only upon costs but on the exercise of judgment. In the *Colorado Interstate* case, the Supreme Court said "Allocation of costs is not a matter for the slide-rule. It involves judgment on a myriad of facts. It has no claim to an exact science." (324 U.S. at p. 589).

Expressing all of the factors quantitatively, we find that when we take the Btu content of a standard measure of gas, an Mcf, and compare it with the Btu content of a standard measure of oil, a barrel[26] the ratio of gas to oil is about one to six.[27] However, on the basis of Phillips' prices in the field, the ratio is about one to 33 for the year 1954. We can conveniently apply a factor to the Btu ratio that will have the effect of correcting its unreality and of avoiding imposing costs on gas consumers which should fairly be borne by the consumers of the ultimate products of the crude oil but also require gas to bear its proper share of the costs. Upon the basis of the considerations expressed above, and the record in this proceeding, we are of the opinion that the proper economic factor to be applied to the straight Btu content of oil to allocate Phillips' test year exploration costs is four, so that the cost relationship of finding one Mcf of gas to one barrel of oil will be about one to 24.

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[25] See *Atlantic Seaboard Corp., et al.*, 11 FPC 43, 53; *Canadian River Gas Co.*, 3 FPC 32, 61, affirmed as *Colorado Interstate Gas Co.* v. *F.P.C.*, 324 U.S. 581, 586; *Cities Service Gas Co.*, 3 FPC 459, 485, affirmed *Cities Service Gas Co.* v. *F.P.C.*, 155 F. 2d 694, 704 (CA 10), *certiorari denied*, 329 U.S. 773.

[26] 42 gallons.

[27] The actual ratio ranges from 1 to 5.5 to 1 to 6, depending upon the Btu content of the particular oil and gas involved.

Our result is reached by an exercise of administrative judgment applied to the facts of the record as discussed above, p. 13, in connection with *S.E.C.* v. *Chenery Corp.*, 332 U.S. 194. We have made a determination on the basis of the record, which, however, did not lead us to the precise conclusion. However, we are of the opinion that our allocation factor is as well, if not better, supported than our *Seaboard* rule that fixed costs should be classified fifty percent to the commodity charge and fifty percent to the demand charge.

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[Mimeo., p. 30]

Our result might be different in other proceedings under different circumstances. In this case we are not determining rates for the future but are terminating proceedings not only with respect to the future but also, with two limited exceptions, for the past periods involved in the twelve Section 4(e) dockets here consolidated. In determining rates for the future we might arrive at a somewhat different result upon weighing the factors discussed here.

As may be observed, our result differs from the one to 33 ratio that would be obtained from the use of Phillips' test year sales realizations alone. It also differs from the approximately one to 34 ratio that would be obtained using the relative production costs alone. We do not reach our conclusion by modifying either production costs or sales realization, but rather by modifying the fundamental Btu relationship, because it is the Btu content that is the fundamental quality of fuels. Thus this economic factor is applied to the Btu or common fuel value of oil produced by Phillips to relate its Btu's to the joint exploration costs in the light of all of the circumstances developed in the record. The ratio we adopt to allocate Phillips' exploration costs thus gives more consideration to the relative Btu contents than does the relative test year realizations, or relative production costs, gives effect to the upward trend of gas production

relative to oil in relation to the present level of exploration costs, and recognizes the increasing contribution that Phillips' current exploration costs are making to gas supplies as compared with oil. We believe that using such a ratio, and also fixing all gas rates on the basis of costs thus obtained will be of great benefit to consumers and producers alike. We consider the problem of bringing gas to market so important that we have not confined ourselves to a method that considers only historical relationships for the gas currently produced and leaves unresolved the cost basis for determining the rates for the additional gas that customers are demanding now, or will need in the future.

The adjustment factor of 4 which we have applied to the Btu ratio of oil to gas, while based on judgment taking the above factors into consideration, is confirmed by the actual trend of prices. The record shows that the ratio of the price of a barrel of petroleum to an Mcf of gas at the well head produced by Phillips ranged from 39 to 1 in 1952 and 33 to 1 in 1954, down to about 29 to 1 in 1956. If this trend were extended, the ratio would reach our 24 to 1 in 1958. Similarly, the record shows that nation-wide the same ratio was 32.5 to 1 in 1952 and 27 to 1 in 1954. We may take notice that as shown by figures published by the Bureau of Mines, this trend, with certain ups and downs, continued, reaching 25.3 to 1 in 1958 and, if extended, would have reached a ratio of around 23 to 1 in 1959.

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[Mimeo., p. 31]

In carrying out the computation (as set forth in Appendix 6), we use an allowance for the Btu's in the Mcf of gas ranging from 1025 for the dry gas and San Juan gas to 1250 for the casinghead gas, while we use an allowance of 5800 Btu's for a barrel of oil and 5500 Btu's for a barrel of condensate. After computing the total amount of Btu's for the various types of gas and for oil and condensate based on

volumes and employing the factor or four discussed above, we allocate $47,474,039 of exploration and development expenses 32.742 percent to gas and 67.258 percent to liquids. This amounts to 3.485 cents per Mcf of gas and 73.71 cents per barrel of liquids. We then allocate return and taxes amounting to $10,839,194 on exploration and development investment between gas and liquids on the basis of the same percentages. The total exploration and development cost, including return for gas become. 4.281 cents, while it amounts to 90.54 cents for liquids. The gas here includes condensate gas from which other liquids will be removed in the gasoline plants resulting in a further allocation of cost to liquids. The 4.281 cents per Mcf figure that we have reached for gas is a reasonable allowance for exploration and development based upon our knowledge of other companies in the industry. However, it will vary from company to company depending upon the relative amounts of the gas and liguids produced, the levels of output, the results of its exploration and the areas in which it operates.

In making our allocation of exploration and development costs, an adjustment was made for the proven gas reserves owned by Phillips in the San Juan Basin during the test year 1954 but sold in place to Pacific Northwest in 1955 with an overriding royalty retained. In making this adjustment, it was assumed that exploration and development costs in the test year were associated with production from the San Juan Basin as well as with production from Phillips, properties retained. Phillips, itself admits,[28] that the San Juan royalties, of course, must bear some portion of current exploration expenses. What we have done is to normalize the gas royalty production of the San Juan Basin upward to reflect the normal recurring royalty production in subsequent years. Our treatment is consistent with the treatment

[28] Brief, p. 127.

of additional expenses arising from wage increases and our general policy of giving effect to known operating charges occuring within a reasonably short time after the close of the test year.

Although the actual production from the San Juan Basin during the test year was small, it was assumed that the volumes would be produced over an estimated life of 20 years, or 60,750,000 Mcf per year. Such a production period for gas wells is supported by the record and is consistent with our general requirements for gas supplies prerequisite for granting certificates. Our computation results in allocating $2,278,279 of exploration and development expenses to the San Juan gas, making a total of $2,452,98? allocated to royalties compared with the examiner's $7,558,299.

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[Mimeo., p. 32]

ALLOCATION OF COSTS BETWEEN NATURAL GAS AND EXTRACTED LIQUIDS

As the examiner shows, Phillips sells residue gas and certain liquids, including gasoline, from the gasoline plants which it owns in the various fields. The question arises as to how to treat these sales in relation to cost of service. The first question is whether the gasoline plant operations should be considered jurisdictional, in which case the gasoline plant costs and revenues would have to be reflected in the jurisdictional gas cost of service, or whether the gasoline plant operations should be considered non-jurisdictional, in which case some method is necessary for allocating costs between the liquids separated in the gasoline plants and the residue gas. We are of the opinion that the examiner was correct in concluding that the gasoline plant operations are non-jurisdictional. The examiner goes into this matter thoroughly and his presentation, which we adopt, need not be repeated here. The record shows that the gasoline plant operations constitute a business for the benefit of Phillips

rather than for the purpose of rendering the gas fit for pipeline transportation. The present situation differs from that involved in the *City of Detroit* case,[29] where the court held that the extraction operations were clearly within the jurisdiction of the Commission. In that case, Panhandle Eastern Pipe Line Company was both a producer and a pipeline company, and the court was impressed with the Commission's finding that the extraction of the heavier hydrocarbons did improve the efficiency of Panhandle's pipeline system along with the fact that the extraction process was incidental to the over-all pipeline transmission and resale operations. Here, on the other hand, Phillips is an independent producer without a pipeline system selling various products, oil, residue gas, gasoline etc. The production of gasoline and other liquids in the gasoline plants is not a mere incident to the sale of gas. It is an independent business, which is not subject to our regulation. There is thus only a question of the proper method of allocating costs to the separate products.

Our problem then, is to take the raw gas as it enters the gasoline plants with the exploration costs and the production costs assigned to it and determine what portion of the costs adherent to the raw gas is applicable to the residue gas leaving the gasoline plants. A number of methods to accomplish this were presented. A witness for the staff employed a relative value method which depended upon a market value for the gasoline and the gross realization from the sale of the residue gas. Wisconsin's witness presented what was known as the single marketable product method, in which he assumed in turn that the gas and then the liquids were waste products and obtained a justifiable cost of residue gas and a justifiable cost of liquids at the tail gate of the gasoline plants. In arriving at the justifiable cost of liquids, he substituted actual revenues as the

[29] *City of Detroit* v. *F.P.C.*, 230 F. 2d 810 (CADC), certiorari denied 352 U.S. 829.

measure of their cost on the ground that the liquid revenues were lower than the combined cost of gas and liquids when assuming gas was a waste product. He eventually constructed a ratio of the justifiable cost of residue gas to the sum of the justifiable cost of residue gas plus the justifiable cost of natural gas liquids with a net result of allocating 28.40 percent of the costs to liquids and 71.60 percent to gas, based thus on all costs to the tail gate of the plants.

The witness for the Eastern Companies used a sales realization method, modified by adjusting downward the book revenues for natural gas liquids so as to eliminate plant processing costs and by adjusting upward Phillips' revenues from residue gas so as to reflect the same 1956 new contracts average price of 13.47 cents which he had used for the allocation of exploration costs under the RAR method. The examiner followed the sales realization method recommended by the Eastern Companies. However, he concluded that it should be corrected so as to exclude return and related taxes on gasoline plant investment in addition to plant processing costs. He reasoned that the price of the residue gas truly represents the value of the residue gas in the wet gas stream, but that in the case of the liquids, the price is substantially affected by the gasoline plant processing operation so that total gasoline plant costs should be deducted, including taxes and return. As modified by the presiding examiner, the sales realization method resulted in allocating 16.7881 percent of the raw gas costs to liquids.

Phillips employed a Btu method. It charged the investment and operating costs of the gasoline plants wholly to the liquids. There was thus left for allocation only the joint costs of the raw gas stream at the inlet of the plants. Phillips performed this allocation in steps by what it called the volumetric Btu method. In the first step, an allocation of costs was made on the basis of the volumes of residue gas de-

livered by the plant compared with the reduction in the volume of the raw gas resulting from the returns of gas to the leases and the extraction of the liquids. In a second step, the allocation was adjusted to account for the loss of heating content in the residue gas as compared with the raw gas. Both reductions result in allocating 16.7202 of the relevant joint costs of the raw gas to liquids.

We are of the opinion that the Btu method is appropriate and simple for the allocation of costs to the products of the raw gas stream, and that it will not be necessary to bring in the factor of market price as we did in connection with exploration costs. We agree with the examiner that the single marketable product method of Wisconsin, which also makes use of revenues dependent on market prices, is highly artificial in addition to being subject to the defects of the realization methods. In support of the Btu method, we note first, that all of the products of the raw gas stream are in a gaseous state when entering the gasoline plants, so that the situation is different from that we face in allocating costs between oil and gas. Secondly, the extraction of these liquids reduces both the volume of gas and its Btu content. Furthermore, Btu measures a significant characteristic common to all of the components of the raw gas stream, that is the ability to produce energy. Oil, more than the natural gas liquids, has many uses other than fuel,

and so, as we have said, is not adaptable to a straight Btu method. By making cost allocated to residue gas dependent on Btu content, the operator of gasoline plants will not remove hydrocarbons from the gas stream unless they would interfere with the transportation of the gas or unless they would command a price out of all proportion to their Btu content when left in the gas stream. Unnecessary and costly removal of products from the raw gas will thus be avoided.

The Btu method is useful and simple for our present purposes, and it reaches a reasonable result, not very different, as will be seen, from that reached by the examiner on the basis of his modification of the sales realization method.

As noted, Phillips carried out the Btu method in steps. What it did was to reduce the total volume of gas gathered, 687,145,852 Mcf by the raw gas sold from the system, 18,845,896 Mcf, a reduction of approximately 2.7 percent. It then reduced the balance of raw gas, 654,863,239 Mcf by the loss in the gasoline plants due to the extraction of the liquids and the return of gas to leases, a reduction of some 9.5 percent. Phillips applied the 2.7 percent to the total raw gas costs[30] in order to allocate costs to raw gas sold. It also applied the 9.5 percent to the total raw gas costs to obtain an allocation of costs to liquids. We think that the 9.5 percent should have been applied to the costs, rather, of the gas remaining after the sale of the raw gas, for that is the way the 9.5 percent was derived.

Phillips then computed a percentage reduction in Btu content per Mcf from raw gas to residue gas amounting to about 7.6 percent.[31] It applied the 7.6 percent to the balance of raw gas costs after the deduction of the 2.7 percent and the 9.5 percent. The 7.6 percent represented an addition to the liquids cost, and the balance represented cost of the residue gas. As a final step, Phillips added back the costs allocated to raw gas sold to obtain a total cost of system sales, $95,329,193, which it allocated on a volumetric basis 28 percent to non-jurisdictional sales and 72 percent to jurisdictional system sales.

Apart from the error that we believe Phillips made, we think that this step method is unduly complicated and with-

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30 Gas purchases, lease production—cost of service, and gathering system—cost of service.

31 Btu content of inlet gas was 1151 Btu and of residue gas was 1063 Btu 1151—1063=88; 88÷1151=7.6 percent.

out any necessary logical foundation. The allocation of raw gas costs to extracted liquids, raw gas sold and residue gas can be performed more simply on the basis of aggregate Btu.

32677

[Mimeo., p. 35]

The computation is performed in Appendix 9. This shows the total gas produced and purchased amounted to 783,675,122 Mcf. This is divided on the basis of volumes into field sales and total gas gathered, the latter amounting to 687,145,852 Mcf. The total gas gathered on the basis of volumes is distributed to raw gas sales in the amount of 18,845,896 Mcf and residue gas sales amounting to 592,282,042 Mcf, leaving 76,017,914 Mcf representing returns of gas to leases and the loss in volume resulting from the extraction of the liquids, etc. These amounts are then converted to Btu's using the 1151 Btu's per Mcf for the gathered gas and raw gas sales and 1063 Btu's per Mcf for the residue gas. From the Btu figures obtained percentages are derived, showing that of the total gas gathered, 17.6529 percent is allocable to extraction losses and returns to leases and 79.6045 percent to the residue gas sales. In the computation of the cost of service to be discussed below and shown in Appendix 10, the total cost of produced and purchased gas is reduced by the 17.6529 percent, representing the extraction liquids and returns to leases.

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[Mimeo., p. 36]

RATE BASE

The examiner used a 1954 year-end rate base, while the staff, Wisconsin, the Southern California Companies, and the Michigan Commission excepted, saying an average rate base should have been used. In past cases dealing with pipelines and electric companies we have traditionally used the average rate base although we have indicated that we might

consider the year end balances in a proper case. *United Fuel Gas Company*, 12 FPC 251, 255; *Otter Tail Power Company*, 8 FPC 393, 400-401. The examiner has pointed to evidence showing that over a period of years Phillips' investment has been steadily increasing presumably, in part, because of the increasing costs of drilling for gas. In a company with such a rapidly expanding need for investment, we are of the opinion that the average test year rate base is not as representative of succeeding years as the year-end test year rate base, and therefore we agree with the examiner that year-end should be used. This does not mean that we shall not ordinarily require the average rate base in electric and pipeline rate cases.

In its exceptions, the staff objected to the inclusion in the rate base of $17,765,332, representing undeveloped offshore leases, title to which was held by a subsidiary of Phillips during the test year. The subsidiary was dissolved in 1955 and the offshore leases were transferred to Phillips. The testimony indicated that, upon investigation, Phillips decided that the leases should be owned by the parent company. We have no difficulty in agreeing with the examiner that Phillips and its subsidiary should be treated together. In view of the necessity that all producers acquire additional reserves, we think that these reserves should be properly included in its rate base even though there was no production from them during the test year in the absence of a showing that holding these reserves without producing gas from them was unwarranted. In another proceeding where the record shows that leases owned by the producer had been developed but were being held without producing, it might be reasonable to exclude them from the rate base. For similar reasons, we agree that the examiner properly included in the rate base additional undeveloped leases, which with the offshore leases, totalled $76,347,908 in the test year 1954.

(32678)

A somewhat different problem is presented by the inclusion in the rate base of $8,430,758, representing net investment in the San Juan producing leases which were transferred to Pacific Northwest Pipeline Corporation in November of 1955. Wisconsin and the Southern California Companies both exempt to the examiner's inclusion of this item. They argue variously that the jurisdictional revenues received from the properties during the test year amounted to only $141,968 and that the revenues received from Pacific Northwest would be considered part of Phillips' non-jurisdictional business. We are of the opinion, however, that the examiner was correct in the position he took with respect to this item. The fact that reserves owned during the test year did not produce revenues is not sufficient ground to exclude them from the rate base, for reserves are often obtained and properly held for future needs because of conditions beyond the control of the producer.

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[Mimeo., p. 37]

Furthermore, the record shows that additions to Phillips' Gas Department properties in the year 1955 not only replaced the San Juan reserves dollar for dollar, but added some seven million dollars to the net investment over and above the depreciation and depletion that was recorded in that year. Therefore we can conclude that eliminating the San Juan reserves from the 1954 test year rate base would not make that rate base more representative of the future. Phillips is continually obtaining reserves, and at certain times it has disposed of reserves, so that the actual reserves at hand in the test year are appropriate for inclusion in the rate base.

Finally, the Michigan Commission contends that certain "general and service" assets should have been excluded from the rate base. These assets are referred to by the examiner as a hotel, a lodge, a hospital, patents and trademarks. While these items as applicable to the entire com-

pany amount to $2,31,539, the adjustment as proposed by the staff would reduce the rate base by only $324,055. The staff had employed a short-cut method of adjustment as did Phillips by a somewhat different means. The examiner did not make an adjustment for these items on the ground that whether the allocation was made by Phillips' method or the staff method, a proper computation would be too complicated for a *de minimis* item. He said that to arrive at a correct result, it would be necessary to make a precise calculation of the total net investment in every general and service assets item which could be regarded as proper investment in order to determine whether the short-cut method fully reflected the entire amounts properly chargeable for each of such legitimate items. We agree with the examiner that under the circumstances no adjustment is appropriate for this item.

The matter of working capital was not a subject of controversy in the exceptions. However, since we recompute the amount employed by the examiner some explanation is desirable. The examiner accepted Phillips' claim in the amount of $29,841,420[32] and none of the other parties took specific exception thereto although Wisconsin's witness had stated that the amount was supported by insufficient evidence. The record, in fact, is deficient in support of Phillips' claim. The company's exhibit does set forth its amount for working capital divided into various categories[33] but does not show the method by which those amounts were reached.

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[32] The examiner actually shows $8,028,654 for the jurisdictional portion of the working capital.

[33]

Production facilities, dry gas leases	$ 6,281,978
Gathering facilities	3,209,581
Residue facilities	129,826
Oil production facilities, 100 percent oil leases	4,445,736
Oil and gas and cycling production facilities, joint product leases	15,774,299
	$29,841,420

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[Mimeo., p. 38]

As set forth in Appendix 3, we compute an allowance for working capital in the amount of $19,929,483. This amount is developed from evidence in the record using the methods that we have employed in previous cases dealing with electric companies and pipeline companies, and we see no reason why the same method may not be applied for the independent producers. Upon the basis of total direct, indirect and exploration expenses as allowed by us in this proceeding, less certain non-cash items, such as taxes and depreciation, we reach an amount for cash requirements, equivalent to operating expenses. One eighth of this, or 45 days' expenses we allow in the working capital. We then add the allowance for materials and supplies and prepayments to arrive at a total of $19,929,483.

Upon the basis of the considerations expressed above and including the allowance for working capital, we find that the proper rate base for Phillips including the Natural Gas Department, the Oil and Gas Department, exploration and development, gathering system and gasoline facilities and residue system, amounts to $424,775,939 as shown in Appendix 2.

32681

[Mimeo., p. 39]

RATE OF RETURN

The question of rate of return has been a matter of controversy in this proceeding as in many others, but there are involved here a number of considerations that we have not had to face in pipeline proceedings. The staff recommended a rate of return of 9 percent for Phillips, employing a method that utilized the earnings price ratio of Phillips equity securities and those of other companies. The examiner, in general, followed this method, but made a modification in the computation of the debt ratio and reached a

rate of return of 9¼ percent. Phillips opposed the earnings-price ratio method, but modified this method and used it in conjunction with a method based on data published by the Internal Revenue Service and a method based on a comparison of Phillips' earnings on investment with the earnings on investment of producing companies of an allegedly corresponding risk. Using these methods, Phillips contended for a rate of return of approximately 12 percent, in addition to the benefits of the tax incentives discussed below or a rate of return of 17 to 18 percent if the retention of the tax benefits were denied.

In order to reach a fair rate of return for Phillips, we will not employ any formula rigidly. This is a matter which "depends upon many circumstances and must be determined by the exercise of fair and enlightened judgment, having regard for all relevant facts." *Bluefield Water Works and Improvement Co.* v. *P.S.C.*, 262 U.S. 679, 692-693. The goal of our inquiry is stated in *F.P.C.* v. *Hope Natural Gas Co.*, 320 U.S. 591, 603, where it is said that there must "be enough revenue not only for operating expenses but also for the capital costs of the business" including "service on the debt and dividends on the stock." Te return to the equity owner must be "commensurate with returns on investment in other enterprises having corresponding risks" and "sufficient to assure confidence in the financial integrity of the enterprise so as to maintain its credit and to attract capital." This is another situation where we must apply our judgment to a multitude of interrelated facts which cannot all be weighed mathematically, but nevertheless we must reach a decision and in doing so shall take such factors into consideration which appear to us relevant.[34]

Before discussing the specific question of what rate of return is fair and reasonable for Phillips we should consider the effect of certain tax

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[34] See p. 13, citing *S.E.C.* v. *Chenery Corp.*, 332 U.S. 194 and other cases.

incentives arising from the internal revenue code. Under the present tax law, provision is made for certain additional deductions which have the effect of lowering Federal income taxes payable. The question has arisen whether the benefit of those tax provisions should belong to Phillips, the taxpayer, or its customers and the consumers. That is, whether Phillips' cost of service should be computed without utilizing these tax deductions while at the same time taking advantage of them on its tax return. The examiner used actual taxes payable in his computation of cost of service. Phillips and certain of the interveners argued that the benefits should be retained by it.

The additional tax deductions in this proceeding relate to percentage depletion under Section 613 and intangible drilling and development costs under Section 263(c). These provisions have been discussed in previous decisions by us,[35] and it will only be necessary here to cover them briefly.

The percentage depletion incentive arises from Section 613 of the Internal Revenue Code as an alternate to the "reasonable allowance" standard of Section 611, which in practice means depletion on a cost basis. Under Section 613, the allowance for depletion on oil and gas wells is the lesser of either 27½ percent of the "gross income" or 50 percent of net income. An option to deduct as expense the intangible drilling and development costs under prescribed regulations is continued by Section 263(c) of the Internal Revenue Code of 1954. Proposed regulations provide that the owner of an operating mineral interest in oil or gas wells may at his option deduct, that is, "expense" intangibles, including amounts spent for labor, fuel, repairs, hauling and supplies in drilling wells, clearing ground and construc-

[35] *El Paso Natural Gas Co.*, 22 FPC 260, 265-269, reversed as *El Paso Natural Gas Co.* v. *F.P.C.*, 281 F. 2d 567 (5th Cir. 1960); *United Fuel Gas Co.*, 22 FPC 127, 512.

tion. In other words, instead of capitalizing the intangibles and depleting them over the life of the well, the producer may deduct them in the year incurred. See proposed Regulation § 1.612-4(a), (d), 603 C.C.H. 3552 and the corresponding regulations under the 1939 Code, Regulation 11 § 39.23 (m)-16(a) (d). In our *El Paso* and *United Fuel* decisions, we concluded that when the percentage depletion and intangibles provisions are considered together in relation to the taxpayer's property as a whole, they result in a tax saving rather than a tax deferral. This is because the percentage depletion deduction depends upon revenues, so that there

is no decrease in deductions for depletion during the life of a gas lease because of expensing the intangibles in the first year. We further concluded in those two proceedings that it was the intention of Congress that the taxpayers should receive the benefit of these provisions. However, since the result was that the taxpayer would receive revenues without a corresponding expense, we said that the tax savings should be considered in determining a fair rate of return.

In the present proceeding for the test year 1954, Phillips had a deduction for depletion in accordance with the tax statute that exceeded the book depletion by the amount of $36,916,206, and a deduction for intangibles expensed in accordance with the tax statute that exceeded the amortization per books in the amount of $7,868,517. Thus a total additional deduction results because of the two statutory tax incentives in the amount of $44,784,723 and a tax saving of $23,288,056, at the tax rate of 52 percent.

By opinion dated August 2, 1960[36] the Court of Appeals for the Fifth Circuit remanded the *El Paso* proceedings.

[36] *El Paso Natural Gas Co.* v. *F.P.C.*, 281 F. 2d 567 (5th Cir. 1960).

The Court concluded that there was no statutory authority for the Commission to treat actual savings in taxes any differently than any other savings, that must be passed on to the consuming public. Therefore no amount representing tax benefits or tax savings could be included in the cost of service. The Court said, however, that "full effect must be given to the Congressional intent to make the several tax savings available to the taxpayer" but not in the form of "additional profits." The savings were available, the Court said, to make it so much easier for the natural gas producers in competition with other fuels and other industries to earn a fair return.

In the present proceeding the tax saving of $23,288,056 amounts only to 6.63 percent on Phillips' well mouth properties. As will be seen, a fair return for Phillips would be at a higher rate than this under the contentions of any of the parties, but whether Phillips receives return as a tax incentive or as a specific allowance, does not affect the result. It must have a fair return on its well mouth, and all of its jurisdictional properties in any case. Therefore, we do not set forth the tax incentives as a specific item in the cost of service, for we are allowing a larger return than permitted by the tax incentives. We may now turn to a consideration of the factors relating to a fair rate of return apart from the tax incentives.

Phillips, as already noted, is a large company with assets of over a billion dollars, whose gas business is only a small fraction of the whole. Such a company is in a very strong position to raise capital. As a company with a continuing program of exploration and production it differs from other companies whose activities are sporadic or are merely holding reserves.

32684

[Mimeo., p. 42]

Phillips argues that it is a fallacy to apply to gas production operations a rate of return based upon the over-all

cost of its capital because of the peculiarly risky nature of the oil and gas production business. It says that the cost of capital for the enterprise as a whole is less than the cost of capital for these risky operations. However, the financing of Phillips and its capital costs are affected by the nature and success of the whole business, and it would be impossible on this record to determine the cost of capital for part of its business. Furthermore, the evidence indicates that the companies that are solely producers have a higher market demand for their equity securities in relation to earnings than the companies with integrated operations. This is possibly because investors sought a hedge against inflation and invested in these stocks in order to acquire a share in raw materials in the ground. In any case, investors, according to the record, appear willing to accept a lower return from purely producing companies than from the integrated companies. Of course, as the examiner points out, the risk inherent in Phillips' producing operations is less than that for the producing operations of the large number of smaller companies. Nevertheless, production of gas creates risk in spite of the willingness of investors to purchase the securities of producers, and this risk must be taken into consideration in arriving at a fair rate of return. We should not base our findings wholly upon a passing tendency of investors.

The presentation by both Phillips and the staff are on the basis of Phillips' capitalization of December 31, 1955. In spite of the exceptions of the Southern California Companies, the capitalization on that date was more representative of the future than in 1954, for an issue of bonds was converted in 1955. Just as we made an adjustment for the related interest deduction for income tax purposes, we shall likewise adjust the capitalization ratio.

(32684)

At the end of 1955 the company's actual debt ratio was 11.6 percent and the cost of it outstanding debt was 3.2 percent as shown by its capitalization:

Long-term Debt	*Amount*		*Cost to Company*
2¾% Debentures, 1964	$28,050,000		2.82%
Subsidiaries' Loans ¾% due 1963	81,000,000		3.36
Subsidiaries' Funded debt	9,120,000		3.00
Purchase obligation	775,583		3.00
Total long-term debt	$118,945,583	11.6%	3.20%
Common Equity			
Common Stock	$455,838,132		
Earned Surplus	443,872,017		
Capital Surplus	1,431,827		
Total Common Equity	$901,141,976	88.4%	

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[Mimeo., p. 43]

There was no dispute about these figures, but the staff contended that Phillips' actual debt ratio and actual cost of debt should be adjusted to reflect as an interest-free loan an item of deferred Federal income tax liability in the amount of $19,162,355, arising from the accelerated amortization provisions of Section 168 of the Internal Revenue Code. This would decrease Phillips' cost of debt to 2.76 percent. The examiner refused to make this adjustment, and we agree. The accelerated amortization provisions were to benefit the taxpayer, not the consumers. They represent an advantage bestowed by Congress to encourage the construction of emergency facilities, and we are not authorized to take away this advantage. *City of Detroit* v. *F.P.C.*, 230 F. 2d 810, 822 (CADC), *certiorari denied*, 352 U.S. 829.

We cannot agree to the exception made by the Michigan Public Service Commission on this point.

In past proceedings dealing with the rates of both electric utilities and natural gas pipeline companies, we have always considered a number of factors in arriving at a proper allowance for common equity and finally a rate of return. In doing so, we have paid considerable attention to the earnings-price ratio of the company involved and other companies similarly situated.[37] The advantage of the earnings-price ratio as a critique is that it shows what investors will pay for the securities of the company involved in relation to contemporary earnings. But earnings-price ratios have pronounced drawbacks in some proceedings, including this one. Investors are interested in contemporary earnings, but they may be interested in other things as well, such as future earnings, possible discovery of large reserves, tax advantages, a hedge against inflation, so that the market price may reflect factors other than earnings. This is apparently true here, for the record shows that while the earnings on the book value of independent producers' equity have declined somewhat from 1949 through 1955, market prices of their stock have risen substantially. Furthermore, it is plain that potential investors in Phillips are not greatly influenced by Phillips' position in the gas business, since but six percent of its gross income comes from this source. While as we said in the *Southern Natural* case[38] the study of earnings-price ratios over a period of years may properly be used with judgment, together with other factors, in determining a reasonable allowance for equity, this is not a case

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[37] *Pennsylvania Water & Power Co.*, 8 FPC 1, 79-80, affirmed *Pennsylvania Water & Power Co.* v. *F.P.C.*, 193 F. 2d 230 (CADC), affirmed 343 U.S. 414; *Michigan-Wisconsin Pipe Line Co.*, 13 FPC 326, Docket No. G-1678, July 30, 1954, mimeo p. 29; *El Paso Natural Gas Co.*, 13 FPC 421 (1954); *Southern Natural Gas Co.*, 24 FPC 26 (1960); *Tennessee Gas Transmission Co.*, 24 FPC 204 (1960).

[38] *Southern Natural Gas Co.*, 24 FPC 26 (1960).

where earnings-price ratios should be a controlling factor in arriving at a fair rate of return.

32686

[Mimeo., p. 44]

While Phillips employed the earnings-price ratio method with adjustments, as already noted it relied on two other methods. One is the earnings-book value approach. By this method there is computed the ratio of earnings to book value of the common equity of comparable companies rather than the ratio of earnings to market price. The earnings-book value ratio is then applied to the equity capitalization. In employing this method, Phillips made use of a staff witness' list of companies, designated *Class A*, which are engaged solely in producing operations. In the seven year period, 1949-1955, Phillips noted that the average earnings-book value ratio for these companies was approximately 19 percent. Assuming an average borrowed capitalization of 14 percent and an interest rate of 4 percent, the 19 percent return on equity capital would result in an average rate of return for the Class A companies of approximately 17 percent, which Phillips contended would be about a reasonable allowance including tax incentives.

Although actual earnings related to book value cannot be decisive in determining a fair return, they constitute an important factor to be considered as showing what comparable companies are earning on the book value of their assets and the relation of Phillips' earnings to their earnings. This approach as employed by Phillips, however, mistakenly relies on the Class A producer companies whose operations differ from Phillips' integrated operations. The examiner notes that the earnings-book value ratios for the Class C integrated companies for the seven-year period used by Phillips amounted to only 15.3 percent, while if the five-year 1951-1955 period had been used, a ratio of only 14.8 percent would be obtained. If a group of 40 companies including both producers and integrated companies is examined, we find that the earnings over the five-year period is approxi-

mately 17 percent on their book value. Phillips' own earnings-book value ratio for the seven-year, 1949-1955 period was 12.1 percent and for the five-year, 1951-1955 period was 12.3 percent.

The other method proposed by Phillips as an alternative to the earnings-price ratio method was based upon Internal Revenue Service data. As stated by the examiner, Phillips' witness used statistical data, published by the Internal Revenue Service, showing balance sheet items and profit and loss statements. Using this data, Phillips' witness computed for the category of crude petroleum and natural gas production, a composite return to equity capital of 11.8 percent for the 1947-1953, seven-year period. Adding an estimated cost of financing of .75 percent, he arrived at a cost rate on common equity of 12.55 percent. This figure, combined with a 3.20 percent rate on debt, produced an overall rate of return of 11.46 percent. Adjusting to compensate for the risk of the "losers", the witness rounded out the rate of return to 12 percent. This method is based on data for companies which are very largely producers only and is subject to the further defect that it reflects only those companies reporting taxable income computed in a somewhat different way than would be net income for rate making purposes.

32687

[Mimeo., p. 45]

We may now consider the earnings-price ratio method as employed by the staff and as modified by Phillips. The staff witness determined an earnings-price ratio of 8.5 percent based on an average for the five-year period, 1951-1955. For this purpose he used a group of 41 companies, including as Class A, those companies which were strictly producers of oil and gas, as Class B, those companies which were producers of oil and gas and were also engaged in refining, and as Class C, the integrated companies producing, refining and marketing. To the ratio of 8.5 percent he added an allowance for the cost of financing of .75 percent and an

investment factor of .75 percent over the "bare bones" cost of equity in order to enable the company to attract capital at reasonable cost, thus reaching a total allowance of 10 percent on Phillips' common equity.

In employing the earnings-price ratio technique, Phillips used the 20-company Class C group and the nine-year period, 1947-1955 to arrive at an earnings-price ratio of 12.9 percent. We agree with the examiner that the appropriate period was the five years, 1951 to 1955, because that reflects the more recent trend of earnings-price ratios. On the question whether to use the 20-company Class C group or the 41-company group, we are in agreement with the staff and the examiner that if the earnings-price ratio method is to be used, the 8.5 percent ratio applicable to the larger group should be employed. While Phillips itself is an integrated company, producing, refining and marketing, the record indicates that the companies in the Class C group are not strictly comparable to Phillips and, furthermore, we are regulating not all of the integrated operations but only the results of producing operations so that some additional weight should be given to such operations. On the other hand, we do not believe it would be appropriate to use the Class A producer group solely, for the financing of the producing operations presumably is affected by the fact that production is combined with refining and marketing. It is of some significance that the earnings-price ratios of the 41-company group for each year from 1947 to 1955 are very close to the earnings-price ratios of Phillips for those years and that the 5-year average for the 41-company group is 8.5 percent while the 5-year average for Phillips is the very close amount of 8.8 percent.

There appears to be no dispute about the staff witness' allowance of .75 percent for financing and this should be added to the earnings-price ratio. More difficulty is created by the allowance of an additional .75 percent over the "bare bones" equity cost. The staff witness testified that the market value of Phillips' common stock should be some-

where in the range from 1.12 or 1.15 times book value, to perhaps, around 1.40 or 1.50 times book value. He was of the opinion that 1.40 times book value would permit the company to maintain its financial integrity and to attract capital on reasonable terms and that if Phillips were given a rate of return somewhere around 9 percent, involving an allowance .75 percent for equity financing and .75 percent as an adjustment over "bare bones" equity cost, the market price would be around 1.40 percent of book value, all other factors being equal. There is no mathematical way to make such an allowance, but some allowance should be made above the "bare bones" cost of equity, and we think that the .75 percent used by the staff witness would be a correct adjustment to make. Phillips multiplied its unadjusted earnings-price ratio of 12.9

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[Mimeo., p. 46]

percent plus the .75 percent financing factor by the 1.40 market factor to arrive at an adjusted cost of common equity of 19 percent, which in turn resulted in an overall rate of return of 17 percent. This method is not only a mechanical method of solving a problem which is a matter for judgment, but arrives at a result which is not required by the demand of the market for Phillips' stock. The two .75 percent adjustments to the earnings-price ratio of 8.5 percent would bring the allowance for common equity up to 10 percent.

In our opinion the various statistical methods do not provide a complete basis for determining a rate of return for an independent producer of gas. It is clear that the risks of this business are greater than those of an electric utility or natural gas pipeline. While we cannot rigidly compare these companies with Phillips, for the circumstances and times are different, we do think that an allowance for common equity for a producer should be comparable to or greater than that for a pipeline company or an electric company. Some of these pipeline and electric cases are as follows:

Name	Citation	Date	Common Equity	Overall Return	Equity Capitalization Ratio
Pennsylvania Water & Power Co.	8 FPC 1	1- 4-49	8.64	5.25	35.71
South Carolina Generating Co. (based on parent South Carolina Electric & Gas Co.)	16 FPC 52	10-24-56	10.5	5.55	27.8
Michigan-Wisconsin Pipeline Co. G-1678	13 FPC 326	7-30-54	10.3	6.00 (pro forma)	31.5
El Paso Natural Gas Co. G-4769	13 FPC 421	11-26-54	14.4	6.00	19.0
Colorado Interstate Gas Co.	19 FPC 1012	6-21-58	12.85	6.00	22.6
Southern Natural Gas Co. Gas Co. G-20509	24 FPC 26	7- 8-60 (pipeline only)	10.18	6.5 (pro forma)	35.8
Tennessee Gas Transmission Co. G-19983	24 FPC 204	8- 9-60 (provisional)	10.12	6⅛	29.5

One plain difference between Phillips and the companies listed here is that Phillips' capitalization consists of 88.4 percent equity and only 11.6 percent debt. This, of course, reduces the risk found in companies of thinner equity. While we believe that Phillips should be granted an allowance for common equity in excess of 10 percent our allowance will be limited by Phillips' high equity capitalization. By this we are not reversing the policy announced in previous cases of encouraging companies to improve their capitalization ratios, for in those cases we were generally dealing with much lower equity ratios as evidenced by the *Michigan-Wisconsin* and *El Paso* cases above.

At the hearing, and in its briefs, Phillips made an extensive presentation designed to show increasing demands for gas by consumers and the producers' increasing problem of supply. As stated by the examiner, the presentation attempted to show the rapidly increasing demand for natural gas, and the failure of discoveries to keep pace with the demand, the increasing depths of drilling resulting in increasing drilling costs, the rising exploration expenditures, the decreasing discoveries per foot of hole drilled, the declining ratio of net earnings to net investment in total gas and oil production and the increasing gas and oil ratios making the producer more dependent than formerly upon income from gas. As stated by the examiner, this evidence appears to relate to rate of return as well as the question of the percentage of exploration costs which should be allocated to gas.

It is clear enough that the national demand for gas is increasing. Phillips' witness estimated that the national demand would increase from 10 trillion cubic foot in 1955 to 15 trillion cubic foot in 1965. It is clear enough that the industry must continue to find additional reserves of gas

and this must come from wells that are drilled ever deeper into the earth and some of them off shore in the Gulf of Mexico. Of course, these deeper wells must be drilled at an increasing cost per foot of depth. It is also true, as Phillips contends, that oil and gas producers must have funds available as their present wells are depleted to drill new wells and find new reserves. Since these new wells will cost a great deal more than the old ones, the oil and gas producers are being faced with the constant necessity of plowing back into their business a substantial part of their revenue above depreciation and depletion accruals.

In view of these practical problems in the gas industry some allowance must be made in the rate of return to promote the continued exploration for and production of gas. The allowance of such an incentive is contemplated by the recent *El Paso* case[39] and the *City of Detroit* case.[40] The amount cannot be determined by any formula, and we can conceive of no evidence that would enable us to reach an amount other than by the exercise of our judgment with all the circumstances in mind.

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[Mimeo., p. 48]

Upon the basis of all the factors discussed above it becomes necessary to determine an allowance for common equity for Phillips. We have noted the comparatively high earnings on equity of the integrated companies and the even higher earnings of the producers, offset by the fact that Phillips' own unregulated earnings on equity have been just a little over 12 percent. Phillips' Internal Revenue data with its disadvantages resulted in a cost rate on common equity of 12.55 percent. The earnings-price ratio method as employed by the staff and the examiner would result in an allowance of 10 percent. But it is clear that

[39] *El Paso Natural Gas Co.* v. *F.P.C.*, 281 F. 2d 567 (5th Cir. 1960).

[40] *City of Detroit* v. *F.P.C.*, *supra*.

something more is needed if that method is employed in view of the allowances we have employed in pipeline cases and the need to encourage continued exploration for and production of gas. As against these factors tending to increase the return, we also bear in mind that Phillips is a large company and well established in the conduct of its gas business, its oil business and its other extensive operations. In these circumstances we think that an allowance for common equity of approximately 12 percent would be fair and reasonable.

Taking the cost of debt capital of 3.20 percent and the allowance for common equity of 12 percent, we compute a fair rate of return as follows:

Allowance		*Capitalization*	
Debt	3.2	11.6	.37
Common Equity	12.0	88.4	10.61
			10.98 percent

The overall rate of return of 10.98 should be rounded off to 11 percent. As such we believe that it takes into account all factors necessary for determining a fair return and includes all that is required from the constitutional or the regulatory point of view.

As noted previously tax incentives will not be included in the cost of service. It appears from the data of record that the sum of the additional tax deductions for statutory depletion, intangible well drilling costs and interest expense would amount to $46,680,450. This is approximately $44,900 less than the return allowed of $46,725,353 (See Appendix 2). Accordingly, we shall add an amount rounded to $45,000 to the cost of service to provide an allowance for Federal income tax taking into consideration in this tax allowance the effect of a very small credit to working capital. Because

of its small amount we do not show this credit as an actual deduction from working capital.

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[Mimeo., p. 49]

COST OF SERVICE

On the basis of the foregoing discussion in connection with the decision of the examiner, we determine Phillips' cost of service for its jurisdictional gas operations in the amount of $55,548,054 or 11.309 cents per Mcf, as set forth in Appendix 10, subject to adjustment for Phillips' purchased gas costs, royalties, and gathering taxes.[41]

The appendix shows the allocation of the cost of Phillips' own produced gas, in the amount of $37,924,378, between non-jurisdictional field sales, jurisdictional field sales, and costs as delivered to gathering systems on the basis of volume. In the gathering category are included the $28,180,164 portion of Phillips' produced gas costs, purchased gas costs in the amount of $30,320,225, and gathering system and compressing costs in the amount of $18,452,321. These costs are distributed between raw gas sales, liquids extracted, and residue sales on the basis of Btu's as previously discussed. The costs allocated to residue sales plus residue system costs and costs allocated to raw gas sales are then

[41] The examiner allowed increased royalties and gathering taxes in Phillips' cost of service as computed by him to reflect increased revenues resulting from his determinations. There is no question that such an adjustment is proper. If the cost of service determined by us were translated into revenues, we estimate that Phillips' royalties and gathering taxes would be increased by approximately $1,500,000. Likewise, we estimate that Phillips' purchased gas costs as a result of the operation of the percentage-type casinghead contracts of its suppliers on an overall basis would be increased by approximately $3,700,000. There is no purpose in making an exact computation here because the cost of service computed by us exceeds Phillips' revenues, and we are terminating all proceedings (with two irrelevant exceptions). However, if the computation were made on the basis of revenues reflecting our cost of service, our adjusted cost of service would exceed that computed by the examiner.

allocated between non-jurisdictional sales and jurisdictional sales. To the jurisdictional costs are added cost distributed to the jurisdictional field sales and regulatory commission expense to arrive at the total cost of jurisdictional service of $55,548,054 or 11.309 cents per Mcf, subject to redetermination for purchased gas costs, gathering taxes and royalties.

32692

[Mimeo., p. 50]

RATES

Having determined Phillips' cost of service, the next step would ordinarily be to alter Phillips' rates to reflect this cost of service. We are authorized in an investigation under Section 5(a) to determine rates prospectively and, of course, we can determine rates for the past periods with respect to the rate schedules involved in the Section 4(e) proceedings consolidated with this investigation. However, a very serious problem is before us.

We may first note the greatly varying contentions of the parties. In these proceedings Phillips contended for a uniform rate applicable to sales to all of its customers[42] subject to adjustment for point of delivery, pressure, dehydration and amount of sulphur (whether sweet or sour). The examiner used the company-wide method, but in their exceptions a number of the interveners objected vigorously and advocated variously other solutions, such as basing the rates on the existing contract rates or field prices. The staff advocated an area method of setting rates. On oral argument Phillips stated that it was not wedded to any particular system of rates as long as it recovered its total cost of service, and the State of Wisconsin and the California Commission which had objected to company-wide

[42] Except with respect to percentage-type casinghead contracts.

rates, admitted the record was insufficient to support other methods and withdrew their objections.

As already indicated, Phillips' operations are conducted in widely separated areas, and it produces gas of varying qualities and serves diverse customers under different conditions. Physically, Phillips owns gathering systems and holds leases in Kansas, in central Oklahoma, in the Panhandle of Oklahoma and Texas, in eastern New Mexico and western Texas along the Gulf Coast of Texas, in eastern Texas and other scattered localities. Its jurisdictional sales are represented by hundreds of rate schedules on file with this Commission.

The present proceeding involves an investigation of Phillips' rates on the basis of a record including evidence on the alternate test years 1954 and 1956 of which we chose 1954 in accordance with the decision of the examiner. From our knowledge of the industry, it is clear enough that costs and prices of gas in the field have greatly increased since that time. For instance, we have suspended approximately 95 rate changes filed by Phillips subsequent to the hearing in these proceedings. Some of its more recent filings involve substantial increases.[43] Therefore we do not deem it appropriate to prescribe

or require that Phillips file rates for the future based upon the present record. In fact, if this order provided for rates

[43] For example see the following increases:

Buyer	Docket No.	Amount Suspended	Effective Subject to Refund
Michigan-Wisconsin P. L. Co.	G-19032	$1,610,504	1- 1-60
Panhandle Eastern P. L. Co.	G-19845	2,717,526	3-26-60
El Paso Nat. Gas Co.	G-18417	2,212,264	1- 1-60
El Paso Nat. Gas Co.	G-20404	1,090,103	6- 2-60
El Paso Nat. Gas Co.	G-20403	3,385,616	6- 1-60

for the future effective in 1960 but based on the test year 1954, it might easily occur that the rates approved here would be lower than those approved in some of Phillips' suspension proceedings now before us. The consequence of this would be that Phillips would be required to decrease its rates in 1960 based upon an earlier test year, a result without reason or justice.

As a result we shall terminate the rate investigation proceedings in Docket No. G-1148 under Section 5(a). Phillips' customers will not be substantially injured, for Phillips' rate filings have been subject to our continuing surveillance and many large increases filed by it have been suspended under Section 4(e) of the Act and are currently the subject of proceedings before us. Furthermore, there is nothing to show that Phillips' contracts relating to Phillips' diverse conditions of sale are unduly discriminatory or preferential. Additionally its customers and consumers will receive the protection of our area pricing standards announced at this time. Phillips will not be injured, for we are thus leaving in effect its contract structure; it has had the privilege of filing increased rates and has done so in substantial amounts as already noted.

Our approach must be similar with respect to the twelve Section 4(e) proceedings consolidated herewith. Except in one minor case[44] all of these proceedings involve rates which have become effective after the test year, but have been superseded by other rates suspended by us in other proceedings. They must be considered in the light of the record in this case which is based on the cost of service method of regulation, but our conclusions here should not bind future determinations of Phillips' rates either in Section 4(e) proceedings or rate investigations under Section 5(a). The record in this proceeding indicates that these rates

[44] Phillips' Rate Schedule No. 68 for service to Cities Service Gas Co. involving an increase of $21,324, suspended by us in Docket No. G-8623 until May 1, 1955 is still in effect.

have produced revenues less than Phillips' cost of service during the periods that they were in effect. The cost of service determined by us of $55,548,054 or 11.309 cents per Mcf is substantially in excess of Phillips' applicable jurisdictional revenues of $45,568,291.

Although there is considerable diversity among the rates, there is nothing in the record to show that these past rates reflecting the different conditions of sale are unduly discriminatory or preferential. To allocate costs to each of them would require reopening the proceedings and the introduction of elaborate evidence. Little would be accomplished by way of adjusting them in any case since neither Phillips nor this Commission have authority under the Act to increase any of them retroactively above the filed level. On our part we would like to disturb area rate patterns as little as possible, particularly on a retroactive basis, having in mind the involved business arrangements that have arisen between the producers and their customers as the industry has developed. We thus find no purpose in continuing the Section 4(e) proceedings and will order that they be terminated with two exceptions discussed below.

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[Mimeo., p. 52]

Our disposition made here avoids the necessity of dealing with the many questions raised in this proceeding as to Phillips' rates, but one question remains, and that is whether with respect to certain contracts Phillips was authorized to file increased rates. Under the *Mobile* case,[45] of course, a seller of gas may not file an increased rate unless contractually authorized. Phillips filed increased rates for service to El Paso, in Docket No. G-11217, to Michigan-Wisconsin in Docket No. G-10793, and to Panhandle in Docket No. G-10883 on the basis that the spiral clauses in its contracts authorized such increases. The examiner found

[45] *United Gas Company* v. *Mobile Gas Corporation*, 350 U.S. 332.

that these clauses in Phillips' contracts with the three companies provided customer consent to increased rates above what would have otherwise been the contract level.

The spiral clauses provide that when the commodity index shall have increased more than a prescribed number of points and a general increase in the customer's rates shall have been put into effect, then Phillips' rates to the customer shall be increased in proportion. Certain of the California interveners contend in their exceptions that the spiral clauses are against the public interest and void, so that they cannot be used as a basis for consent to rate increases. While we do not approve of such clauses in principle, there is not sufficient basis on this record to hold them so derogatory of the public interest as to be void as a matter of law. Therefore, the spiral clauses in this proceeding provide a contractual consent to rate escalations. It may be recalled that the Supreme Court found no invalidity where the contract provided that the buyer should pay the rate the seller had on file with the Commission. *United Gas Co.* v. *Memphis Gas Div.*, 358 U.S. 103. This contract with an unlimited right to file increased rates was not held void; neither have contracts with spiral escalation clauses in them been called void. *Phillips Petroleum Co.* v. *F.P.C.*, 227 F. 2d 470 (CA 10), *certiorari* denied, 350 U.S. 1005; *Kerr-McGee Oil Industries, Inc.* v. *F.P.C.*, 260 F. 2d 602 (CA 10). We emphasize, however, with the examiner that Phillips' costs have been determined in this proceeding independently of any spiral clauses. We need not require that they be eliminated, since Phillips has already agreed to do so.

El Paso argues that the spiral escalation clauses in its contracts with Phillips have not been activated and therefore do not form a basis for Phillips' rate increase filing in Docket No. G-11217, made as a result of El Paso's rate increase filing in Docket No. G-4769. El Paso contends in

its exceptions, dated July 27, 1959, that the contracts clearly provide that Phillips would not be entitled to increased rates until by final decision El Paso's increased rates are finally determined. However, the contracts provide that the price for gas shall be adjusted "when revised rates shall become effective." El Paso's rates in Docket No. G-4769 were allowed to go into effect subject to refund on April 15, 1955, and we agree with the examiner that this provided customer consent to Phillips' rate filing in Docket No. G-11217. We also agree with him that the spiral clauses must be

[Mimeo. p. 53]

given only tentative effect because the rate filing when it became effective was subject to Commission action and court review.[46] Thus, if the amount of the Phillips' escalation increase under the spiral clause as established when El Paso's rates are finally determined, should be less than the amount of Phillips' proposed increase in Docket No. G-11217, the excess portion would be a unilateral increase barred by the *Mobile* doctrine and would have to be refunded.

These same conclusions are also applicable to the similar spiral escalation clauses in the Phillips-Michigan-Wisconsin contracts which are the subject of Docket No. G-10793 and the Phillips-Panhandle contracts which are the subject of Docket No. G-10883. Michigan-Wisconsin made no contention that the escalation clauses were not operative, but Panhandle contends that any increase granted Phillips in Docket No. C-10883 should be conditioned on the effect of a final order in Panhandle's rate proceeding in Docket No. G-2506.

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[46] In Docket No. G-4769, the Commission issued its order determining El Paso's rates on August 10, 1959, 22 FPC 260, remanded by the Court. *El Paso Natural Gas Co.* v. *F.P.C.*, 281 F. 2d 537 (5th Cir. 1960).

Therefore we shall leave pending Docket Nos. G-11217 and G-10883 until a final decision is made either by us or competent court in Docket Nos. G-4769 and G-2506, respectively. At that time Phillips may move that Docket Nos. G-11217 and G-10883 be terminated, and any necessary refunds may be ordered if the rates approved for El Paso in Docket No. G-4769 and for Panhandle in Docket No. G-2506 are not sufficient to permit Phillips under its contracts to file the increased rates involved in Docket Nos. G-11217 and G-10883. Of course, no other matter with respect to these two dockets will remain open.

Our dispositions here leave outstanding almost a hundred other suspension proceedings relating to Phillips' rates. We do not wish to prejudge those proceedings, but it would appear that on the basis of the present record that Phillips' costs probably exceed its revenues at least up through the year 1958, after which very substantial further rate increases were filed by Phillips. Therefore it may be reasonable to terminate a great many of these suspension proceedings, and we invite the filing of motions to this effect on the theory that little or nothing would be accomplished if hearings were held and a determination of Phillips' costs in each case were made. All parties to those proceedings would, of course, have opportunity to object to such motions. We believe this would be a reasonable step to take and it would have the effect of limiting proceedings dealing with Phillips' rates to the year 1959 and later.

32696

[Mimeo., p. 54]

THE SETTLEMENT PROPOSAL

On April 8, 1960, Phillips filed a proposal to settle the present consolidated proceedings. The gist of its proposal is that the Commission would accept all of its contract rates involved and would terminate the various proceedings without refund. It contends that the prompt settlement of these

extended proceedings without court review, otherwise almost certain, would be of great benefit to the Commission, its staff and all segments of the natural gas industry. It adds that the amounts collected by Phillips, subject to refund, are substantial, are increasing each month and may adversely affect Phillips' exploratory program. Phillips notes that under its settlement proposal the annual revenue to Phillips at April 1, 1960, contract prices, from the contracts which were the subject of the present hearing, amounts to $70.8 million, compared to Phillips' claimed cost of service of $92.3 million.

While it is possible that Phillips' proposal may not be unreasonable as a settlement, it was rejected by a number of parties to this proceeding including Southern California Companies, the State of Wisconsin and Public Service Commission of Wisconsin, Minneapolis Gas Company, the Eastern Companies, the Michigan Public Service Commission, and P.G.&E. The grounds given, stated variously, are that the settlement would give Phillips its entire filed rate increase, would be contrary to the findings of the examiner, would be an abdication of regulation, and would fail to settle questions of importance to the industry.

Because of these rejections the settlement proposal may not now be accepted as a settlement. It does not represent a new solution to the issues presented by this proceeding, but rather, acceptance of Phillips' present and past contract prices, many of which are now the subject of other proceedings. We therefore have no basis on which to accept it without agreement of the parties. However, if Phillips desires to renew its proposal or a similiar proposal, it is free to do so, in the light of this opinion and the area pricing standards.

The Commission further finds:

(1) Phillips Petroleum Company is a natural-gas company subject to the provisions of the Natural Gas Act as determined by the Supreme Court of the United States in *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672, and the sales of natural gas for resale which are the subject of this order, are sales of natural gas in interstate commerce and are subject to the jurisdiction of the Commission.

(2) The total jurisdictional cost of service determined for Phillips in this proceeding is $55,548,054, or an average of 11.309 cents per Mcf as set forth in the appendices attached hereto subject to adjustment of purchased gas costs, gathering taxes and royalties.

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[Mimeo., p. 55]

(3) It is necessary and appropriate in the administration of the Natural Gas Act and good cause exists that the proceeding under Section 5(a) of the Natural Gas Act in Docket No. G-1148 and the proceedings in Docket Nos. G-3175, G-4333, G-6621, G-7773, G-8623, G-8695, G-8883, G-10359, G-10793, and G-11125, under Section 4(e) of the Act be terminated and Phillips' obligation to refund excess charges with respect to those dockets be discharged.

(4) It is necessary and appropriate in the administration of the Natural Gas Act that proceedings in Docket Nos. G-10883 and G-11217 remain open pending completion of proceedings in Docket Nos. G-4769 and G-2506 as provided below.

The Commission orders:

(A) The proceedings in Docket Nos. G-1148, G-3175, G-4333, G-6621, G-7773, G-8623, G-8695, G-8883, G-10359, G-10793 and G11125 are hereby terminated and Phillips'

obligation to refund excess charges with respect to those dockets is hereby discharged.

(B) Upon the issuance of a final Commission or Court decision in El Paso's pending Section 4(e) rate proceeding in Docket No. G-4769, Phillips shall file with the Commission a Motion Requesting Termination of its Section 4(e) proceeding in Docket No. G-11217. A determination will thereupon be made of the appropriate Phillips Section 4(e) rates in Docket No. G-11217, based upon the rate increase ultimately approved for El Paso in Docket No. G-4769, but in no event to exceed the rate filed in Docket No. G-11217. The Phillips Section 4(e) proceeding in Docket No. G-11217 will then be ordered terminated, subject to such appropriate refund order, if any, as may be warranted in the event that El Paso's proposed Section 4(e) rate increase in Docket No. G-4769 may not have been approved *in toto*.

(C) Upon the issuance of a final Commission or Court decision in Panhandle's pending Section 4(e) rate proceeding in Docket No. G-2506, Phillips shall file with the Commission a Motion Requesting Termination of its Section 4(e) proceeding in Docket No. G-10883. A determination will thereupon be made of the appropriate Phillips Section 4(e) rate in Docket No. G-10883, based upon the rate increase ultimately approved for Panhandle in Docket No. G-2506, but in no event to exceed the rate filed in Docket No. G-10883. The Phillips Section 4(e) proceeding in Docket No. G-10883 will then be ordered terminated, subject to such appropriate refund order, if any, as may be warranted in the event that Panhandle's proposed Section 4(e) rate increase in Docket No. G-2506 may not have been approved *in toto*.

(D) Exceptions not granted herein are hereby denied.

32698

[Mimeo., p. 56]

(E) The presiding examiner's decision is adopted as the decision of this Commission to the extent not inconsistent with this opinion and order.

(F) The motion of the Mid-Continent Oil & Gas Association to file a brief *amicus curiae* is hereby granted.

By the Commission. Commissioner Kline, concurring in part and dissenting in part, filed a separate statement.

32699

KLINE, Commissioner, *concurring* in part and *dissenting* in part:

I concur in the results reached in this case, namely, the dismissal of the Section 5 (a) proceeding instituted by the Commission against Phillips, and the disposition made by the Commission of the various Section 4 (e) rate increase cases. I do not concur in the cost of service determined for Phillips.

I also concur with the majority (1) that the traditional rate base cost-of-service method of fixing rates is generally neither an administratively practical or economically sound method to use to determine the rates of any individual independent producer, (2) that while ordinarily inappropriate, it can be used in this case to determine the justness and reasonableness of the rates charged by Phillips during the test year 1954 and the several years following as to which the 1954 test year can be considered representative, and (3) that we cannot in this proceeding fix Phillips' present or future rates.

I also concur in most of the methods of allocation and some of the rate-making principles adopted by the majority. I dissent vigorously to the method of allocation of explora-

tion costs proposed and adopted by the majority and to certain of the other rate-making principles and findings contained in the opinion. The adoption of the method of allocation of exploration costs and other rate-making principles which I advocate would not affect the outcome of this case, although it would result in a different cost of service.

There have been many differences between my colleagues and myself on the various issues of this case, on how we should regulate the rates of independent producers in the future, and the extent to which we should discuss these matters in this opinion and in the statement of policy issued this day. Although I deem it entirely too vague and inadequate, I have joined in the statement of policy solely because it represents action rather than inaction.

I shall not at this time set forth my views on these various issues for to do so would result in further delay in the issuance of this opinion. I shall express myself fully on these various matters when we pass upon the petitions for rehearing which will undoubtedly be filed in this proceeding, or at some other appropriate future time.

Arthur Kline, Commissioner

PHILLIPS PETROLEUM COMPANY

COST OF SERVICE
YEAR 1954

Description	Total	Natural Gas Department	Oil & Gas Production Department					
			Total	100% Oil Leases	Joint Products Including Cycling	Exploration and Development	Gathering System & Gasoline Facilities	Residue System
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
DIRECT EXPENSE								
Operating Expense	$ 25,872,563	$ 457,300	$18,281,379	$ 7,811,373	$10,470,006	$ —	$ 6,521,463	$ 612,421
Other Lease Expense	980,725	119,024	831,296	175,601	655,695	—	28,153	2,252
Direct General Expense	13,154	—	13,154	—	13,154	—	—	—
Taxes	10,464,909	1,949,775	2,207,948	1,436,426	6,771,522	—	251,651	55,535
Depreciation	9,712,505	391,562	5,663,500	2,048,409	3,615,091	—	3,487,744	169,699
Retirements & Cost of Retirements	437,140	34,805	330,069	123,688	206,381	—	56,004	16,262
Depletion of Producing Leaseholds	3,123,518	389,459	2,734,059	717,570	2,016,489	—	—	—
Depletion of Intangible Development Cost	19,246,443	1,435,644	17,810,799	4,826,244	12,984,555	—	—	—
Miscellaneous Income	(1,082,490)	(20,989)	(94,377)	(58,279)	(36,098)	—	(962,769)	(4,335)
Net Profits Disbursements	575,638	—	575,638	25,189	550,449	—	—	—
Profit or Loss on Sale of Capital Assets	(125,535)	—	(125,535)	(137,267)	11,732	—	—	—
Total Direct Expense	69,218,570	4,756,580	54,227,930	16,968,954	37,258,976	—	9,382,246	851,814
Percent	100.000	6.872	78.343	24.515	53.828	—	13.555	1.230
INDIRECT EXPENSE:								
Direct General Expense	8,821,980	792,722	5,864,586	1,835,146	4,029,440	—	1,909,203	255,469
Indirect Overhead	11,284,363	2,052,812	7,622,773	2,385,318	5,237,455	—	1,488,631	120,147
Total Indirect Expense	20,106,343	2,845,534	13,487,359	4,220,464	9,266,895	—	3,397,834	375,616
EXPLORATION OPERATIONS:								
Exploration and Development Expense	47,474,039	—	—	—	—	47,474,039	—	—
Return on Exploration Investment at 11%	10,828,765	—	—	—	—	10,828,765	—	—
Federal Income Tax Allowance	10,429	—	—	—	—	10,429	—	—
Total Return and Tax Allowance	10,839,194	—	—	—	—	10,839,194	—	—
Total Exploration Operations	58,313,233	—	—	—	—	58,313,233	—	—
Return on Production Rate Base at 11%	35,896,588	5,688,681	24,094,258	5,385,704	18,708,554	—	5,666,784	446,865
Federal Income Tax Allowance	34,571	5,479	23,205	5,187	18,018	—	5,457	430
Total Return and Tax Allowance	35,931,159	5,694,160	24,117,463	5,390,891	18,726,572	—	5,672,241	447,295
Total Cost of Production, Gathering and Residue Systems	$183,569,305	$13,296,274	$91,832,752	$26,580,309	$65,252,443	$58,313,233	$18,452,321	$1,674,725

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Appendix 2
Docket No. G-1148, *et al.*

PHILLIPS PETROLEUM COMPANY

RATE BASE AND RETURN
YEAR 1954

Description	Total	Oil and Gas Production Department: Natural Gas Department	Oil and Gas Production Department: Total	100% Oil Leases	Joint Products Including Cycling	Exploration and Development	Gathering System & Gasoline Facilities	Residue System
Net Investment	$404,846,456	$50,201,147	$209,530,777	$46,109,957	$163,420,820	$92,069,847	$49,202,880	$3,841,805
Percent	100.000	12.400	51.756	11.390	40.366	22.742	12.154	.948
Gross Working Capital	19,929,483	1,514,138	9,507,932	2,850,985	6,656,947	6,373,469	2,313,335	220,609
Total Rate Base	427,775,239	51,715,285	219,038,709	48,960,942	170,077,767	98,443,316	51,516,215	4,062,414
Return at 11%	46,725,353	5,688,681	24,094,258	5,385,704	18,708,554	10,828,765	5,666,784	446,865
Federal Income Tax Allowance	45,000	5,479	23,205	5,187	18,018	10,429	5,547	430
Total Return and Tax	$46,770,358	$ 5,694,160	$ 24,117,463	$ 5,390,891	$ 18,726,572	$10,839,194	$ 5,672,241	$ 449,295
Interest Calculated								
Total Consolidated Net Assets 1954	$799,360,230							
Interest Expense 1954	9,892,308							
Less:								
Interest Expense on Bonds Converted to Stock	6,149,231							
Total	$3,743,077							
Interest Expense Allowance	3,743,077 = .00468259 per dollar of Consolidated Net Assets							
Total Consolidated Net Assets	799,360,230							
Interest Expense	1,895,730	235,071	981,147	215,914	765,233	431,125	230,397	17,990

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Appendix 3
Docket No. G-1148, *et al.*

PHILLIPS PETROLEUM COMPANY

WORKING CAPITAL
YEAR 1954

Description	Total	Oil & Gas Production Department: Natural Gas Department	Oil & Gas Production Department: Total	100% Oil Leases	Joint Products Including Cycling	Exploration and Development	Gathering System & Gasoline Facilities	Residue System	Remarks

Net Investment	$404,846,456	$50,201,147	$209,530,777	$46,109,957	$163,420,820	$92,069,847	$49,202,880	$3,841,805
Percent	100.000	12.400	51.756	11.390	40.366	22.742	12.154	.948
Gross Working Capital	19,929,483	1,514,138	9,507,932	2,850,985	6,656,947	6,373,469	2,313,335	220,609
Total Rate Base	427,775,239	51,715,285	219,038,709	48,960,942	170,077,767	98,443,316	51,516,215	4,062,414
Return at 11%	46,725,353	5,688,681	24,094,258	5,385,704	18,708,554	10,828,765	5,666,784	446,865
Federal Income Tax Allowance	45,000	5,479	23,205	5,187	18,018	10,429	5,547	430
Total Return and Tax	$46,770,353	$ 5,694,160	$ 24,117,463	$ 5,390,891	$ 18,726,572	$10,839,194	$ 5,672,241	$ 449,295
Interest Calculated								
Total Consolidated Net Assets 1954	$799,360,230							
Interest Expense 1954	9,892,308							
Less:								
Interest Expense on Bonds Converted to Stock	6,149,231							
Total	$3,743,077							
Interest Expense Allowance	3,743,077	= .00468259 per dollar of Consolidated Net Assets						
Total Consolidated Net Assets	799,360,230							
Interest Expense	1,895,730	235,071	981,147	215,914	765,233	431,125	230,397	17,990

PHILLIPS PETROLEUM COMPANY

WORKING CAPITAL

YEAR 1954

Description	Total	Oil & Gas Production Department: Natural Gas Department	Oil & Gas Production Department: Total	Oil & Gas Production Department: 100% Oil Leases	Oil & Gas Production Department: Joint Products Including Cycling	Exploration and Development	Gathering System & Gasoline Facilities	Residue System	Remarks
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Total Direct, Indirect & Exploration Expenses	$136,798,952	$7,602,114	$67,715,289	$21,189,418	$46,525,871	$47,474,039	$12,780,080	$1,227,430	
Less:									
Taxes	10,548,016	1,949,775	8,207,948	1,436,426	6,771,522	83,107	251,651	55,535	Appendix Nos. 1 and 8
Depreciation	10,513,753	391,562	5,663,500	2,048,409	3,615,091	801,248	3,487,744	169,699	Appendix Nos. 1 and 8
Depletion of Producing Leaseholds	3,123,518	389,459	2,734,059	717,570	2,016,489				Appendix No. 1
Depletion of Intangible Development Costs	19,246,443	1,435,644	17,810,799	4,826,244	12,984,555				Appendix No. 1
Expired and Surrendered Leases	9,741,051					9,741,051			Appendix No. 8
Net Profits Disbursements	575,638		575,638	25,189	550,449				Appendix No. 1
Profit or Loss on Sale of Capital Assets	(125,535)		(125,535)	(137,267)	11,732				Appendix No. 1
Total Deductions	53,622,884	4,166,440	34,866,409	8,916,571	25,949,838	10,625,406	3,739,395	225,234	
Cash Requirements—Operating Expenses	$ 83,176,068	$3,435,674	$32,848,880	$12,272,847	$20,576,033	$36,848,633	$ 9,040,685	$1,002,196	
1/8 of Above (45 Days)	$ 10,397,009	$ 429,459	$ 4,106,110	$ 1,534,106	$ 2,572,004	$ 4,606,079	$ 1,130,086	$ 125,275	Exhibit No. 208
Materials and Supplies	7,771,482	963,664	4,022,208	885,172	3,137,036	1,767,390	944,546	73,674	Allocated-Net Investment
Prepayments	1,760,992	121,015	1,379,614	431,707	947,907		238,703	21,660	Exhibit No. 208
Total	$ 19,929,483	$1,514,138	$ 9,507,932	$ 2,850,985	$ 6,656,947	$ 6,373,469	$ 2,313,335	$ 220,609	Allocated-Direct Expense

Appendix 4
Docket No. G-1148, *et al.*

PHILLIPS PETROLEUM COMPANY

SUMMARY OF COST OF PRODUCTION
DIRECT AND ALLOCATED
YEAR 1954

	Natural Gas			Liquids		
	Direct	Allocated	Total	Direct	Allocated	Total
Total Direct Lease Expense	$ 4,756,580	$ 2,743,943	$ 7,500,523	$16,968,954	$34,515,033	$51,483,987
Total Indirect Expense	2,845,534	1,487,555	4,333,089	4,220,464	7,779,340	11,999,804
Return and Tax Allowance	5,694,160	4,316,731	10,010,891	5,390,891	14,409,841	19,800,732
Sub-Total Production	13,296,274	8,548,229	21,844,503	26,580,309	56,704,214	83,284,583
Exploration Operations						
Exploration Expense	—	13,090,967	13,090,967	—	31,930,089	31,930,089
Return and Tax Allowance	—	2,988,908	2,988,908	—	7,290,225	7,290,225
Sub-Total Exploration	—	16,079,875	16,079,875	—	39,220,314	39,220,314
Total	$13,296,274	$24,628,104	$37,924,378	$26,580,309	$95,924,528	$122,504,837
Unit Costs	MCF	MCF	MCF	BBLS	BBLS	BBLS
Volume	226,681,178	149,009,734	375,690,912	13,056,309	30,261,670	43,317,979
Unit Cost			10.095c			$2.83

PHILLIPS PETROLEUM COMPANY

ALLOCATION OF JOINT PRODUCTS INCLUDING CYCLING ON
THE BASIS OF RELATIVE COST
YEAR 1954

Appendix 5
Docket No. G-1148 *et al.*

Relative Cost Method

Cost of Single Product Production

Description (1)	Volume (2)	Amount (3)	Unit Cost (4)
DIRECT EXPENSE:			
100% Oil Leases	13,056,309	$16,968,954	$1.299674663
Natural Gas Department	226,681,178	4,756,580	.02098356838
INDIRECT EXPENSE:			
100% Oil Leases	13,056,309	4,220,464	$ .323250927
Natural Gas Department	226,681,178	2,845,534	.012553022
RETURN & TAX ALLOWANCE:			
100% Oil Leases	13,056,309	$ 5,390,891	$ .41289548
Natural Gas Department	226,681,178	5,694,160	.02511968

Cost of Joint Product Production

	Summary		
Description	Joint Products Including Cycling	Allocated to: Liquids	Gas
(7)	(8)	(9)	(10)
Total Direct Expense	$37,258,976	$34,515,033	$2,743,943
Total Indirect Expense	9,266,895	7,779,340	1,487,555
Return & Tax Allowance	18,726,572	14,409,841	4,316,731
Total	$65,252,443	$56,704,214	$8,548,229
Volume		30,261,670	149,009,734
Unit Cost		$1.87	5.737c

Exploration Operations						
Exploration Expense	—	13,090,967	13,090,967	—	31,930,089	31,930,089
Return and Tax Allowance	—	2,988,908	2,988,908	—	7,290,225	7,290,225
Sub-Total Exploration	—	16,079,875	16,079,875	—	39,220,314	39,220,314
Total	$13,296,274	$24,628,104	$37,924,378	$26,580,309	$95,924,528	$122,504,837
Unit Costs	MCF	MCF	MCF	BBLS	BBLS	BBLS
Volume	226,681,178	149,009,734	375,690,912	13,056,309	30,261,670	43,317,979
Unit Cost			10.095c			$2.83

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PHILLIPS PETROLEUM COMPANY

ALLOCATION OF JOINT PRODUCTS INCLUDING CYCLING ON THE BASIS OF RELATIVE COST YEAR 1954

Appendix 5
Docket No. G-1148 *et al.*

Relative Cost Method

Cost of Single Product Production

Description (1)	Volume (2)	Amount (3)	Unit Cost (4)	(5)	(6)
DIRECT EXPENSE:					
100% Oil Leases	13,056,309	$16,968,954	$1.299674663		
Natural Gas Department	226,681,178	4,756,580	.02098356838		
INDIRECT EXPENSE:					
100% Oil Leases	13,056,309	4,220,464	$ .323250927		
Natural Gas Department	226,681,178	2,845,534	.012553022		
RETURN & TAX ALLOWANCE:					
100% Oil Leases	13,056,309	$ 5,390,891	$ .41289548		
Natural Gas Department	226,681,178	5,694,160	.02511968		

Cost of Joint Product Production

	Volume	Unit Cost	Amount	Percent	Amount Allocated
DIRECT EXPENSE:					
Liquids	30,261,670	$1.299674663	$39,330,325	92.6354899	$34,515,033
Gas	149,009,734	.02098356838	3,126,756	07.3645101	2,743,943
Total			$42,457,081	100.	$37,258,976
INDIRECT EXPENSE:					
Liquids	30,261,670	.323250927	$ 9,782,113	83.947648	$ 7,779,340
Gas	149,009,734	.012553022	1,870,522	16.052352	1,487,555
Total			$11,652,635	100.	$ 9,266,895
RETURN & TAX ALLOWANCE:					
Liquids	30,261,670	.41289548	$12,494,907	76.948634	$14,409,841
Gas	149,009,734	.02511968	3,743,077	23.051366	4,316,731
Total			$16,237,984	100.	$18,726,572

Summary

Description	Joint Products Including Cycling	Allocated to: Liquids	Gas
(7)	(8)	(9)	(10)
Total Direct Expense	$37,258,976	$34,515,033	$2,743,943
Total Indirect Expense	9,266,895	7,779,340	1,487,555
Return & Tax Allowance	18,726,572	14,409,841	4,316,731
Total	$65,252,443	$56,704,214	$8,548,229
Volume		30,261,670	149,009,734
Unit Cost		$1.87	5.737c

Appendix 6
Docket No. G-1148 *et al.*

PHILLIPS PETROLEUM COMPANY

ALLOCATION OF EXPLORATION AND DEVELOPMENT COSTS
YEAR 1954

Description	Volumes	Average Weighted Btu Ratio (Millions)	Total Btu	Application of Economic Factor	Adjusted Btu	Per Cent	Allocated Explor. & Development Expense	Average (8) ÷ (2)	Allocated Return on Exploration & Develop. Invest.	Average (10) ÷ (2)	Total Cost of Explor. Operations	Average (12) ÷ (2)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)
Gas:	*MCF*							*¢/MCF*		*¢/MCF*		*¢/MCF*
Casinghead	70,510,228	1.250	88,137,785	—	88,137,785	5.916	$ 2,808,564	3.983	$ 641,247	0.909	$ 3,449,811	4.892
Condensat	78,499,506	1.150	90,274,432	—	90,274,432	6.061	2,877,402	3.666	656,964	0.837	3,534,366	4.503
Dry, Natural Gas Dept.	226,681,178	1.025 Est.	232,348,207	—	232,348,207	15.598	7,405,001	3.267	1,690,697	0.746	9,095,698	4.013
Sub-Total	375,690,912	—	410,760,424	—	410,760,424	27.575	13,090,967	3.485	2,888,908	0.796	16,079,875	4.281
(B) Overriding Royalty Natural Gas Dept.	5,347,080	1.025 Est.	5,480,757	—	5,480,757	0.368	174,704	3.267	39,888	0.746	214,592	4.013
(C) San Juan Adjustment	69,750,000	1.025 Est.	71,493,750	—	71,493,750	4.799	2,278,279	3.267	520,173	0.746	2,798,452	4.013
Total Gas	450,787,992		487,734,931	—	487,734,931	32.742	15,543,950	3.448	3,548,969	0.787	19,092,919	4.235
Liquids:	*BBLS.*							*¢/BBL*		*¢/BBL*		*¢/BBL*
Oil	40,745,912	5.8	236,326,290	4	945,305,160	63.459	30,126,550	73.94	6,878,444	16.88	37,004,994	90.82
Condensate	2,572,067	5.5	14,146,368	4	56,585,472	3.799	1,803,539	70.12	411,781	16.01	2,215,320	86.13
Total Liquids	43,317,979	—	250,472,658	—	1,001,890,632	67.258	31,930,089	73.71	7,290,225	16.83	39,220,314	90.54
Total Gas & Liquids	— (A) —		738,207,589	—	1,489,625,563	100.000	$47,474,039	—	$10,839,194	—	$58,313,233	—

(A) Btu Ratio from Phillips Petroleum Co., Exhibit No. 310

(B) Calculation of Overriding Royalty, Natural Gas Department,
overriding Royalty, Natural Gas Department, Exhibit No. 316 $447,818
Average Price per Mcf, Natural Gas Department, Exhibit No. 359 8.375¢
Overriding Royalty of $447,818 ÷ 8.375¢ per Mcf = 5,347,080 Mcf

(C) Adjustment for, San Juan Sale to Pacific Northwest Pipeline Company
Estimated Volumes of San Juan Sale 1,395 Billion Cubic Feet
Estimated Life of Production 20 Years
Volume Assigned San Juan Sale
1,395 Billion Cubic Feet ÷ 20 Years = 69,750,000 Mcf Per Annum

Sources of Volumes:
Exhibit No. 388, Schedule 27

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Docket No. G-1148 *et al.*

PHILLIPS PETROLEUM COMPANY

EXPLORATION AND DEVELOPMENT EXPENSES
YEAR 1954

Description	Amount	Reclassification		Total
		Natural Gas Department	Oil and Gas Production Dept.	
(1)	(2)	(3)	(4)	(5)
Phillips Petroleum Company				
Drilling tool income	($7,308,354)	$ —	$ —	($7,308,354)
Clean out & miscellaneous tool income	(217,046)	—	—	(217,046)
Drilling tool expense	6,745,896	—	—	6,745,896
Clean out & miscellaneous tool expense	120,057	—	—	120,057
Undeveloped lease rentals	4,994,085	189,157	163,716	5,346,958
Taxes—exploration	83,107			83,107
Depreciation	801,248			801,248
Retirements—exploration	550			550
Cost of retirements—exploration	261			261
Dry holes—exploration and developmental	11,306,964	1,678,820	4,521,943	17,507,727
Dry holes—contributions	2,025,395	—	—	2,025,395
Expired and surrendered leases	9,479,898	234,721	24,751	9,739,370
Profit and loss from sale of capital assets	1,410	—	—	1,410
Geological, geophysical and land expense	—	3,749,475	8,801,529	12,551,004
Total Phillips Petroleum Company	28,033,471	5,852,173	13,511,939	47,397,583
Phillips Chemical Company				
Dry hole contributions	5,000	—	—	5,000
West Edmond Oil Company				
Undeveloped lease rentals	510	—	—	510
Dry holes—contribution	4,149	—	—	4,149
Expired and surrendered leases	1,682	—	—	1,682
	6,341	—	—	6,341
Phillips Offshore Oil Company				
Undeveloped lease rentals	65,115	—	—	65,115
Total Exploration Expense	$28,109,927	(A) $5,852,173	(B) $13,511,939	$47,474,039

(A) Exhibit No. 282, Page 8, Column (e), Lines 14, 15, 16 and 19.

(B) Land and geological expense from Exhibit No. 282, Page 12.
Undeveloped lease rentals, developmental dry holes, expired and surrendered leases from TR 10,138.

Appendix 8
Docket No. G-1148 *et al.*

PHILLIPS PETROLEUM COMPANY

SUMMARY OF GAS PURCHASES
YEAR 1954

Description	Gas Purchases and Content Cost Statement Volume in MCF	Adjustment to Calendar Year Basis Volume in MCF	Total 1954 Purchased Volume in MCF	1954 Purchased Volumes Adjusted To January 1956 Prices	Unit Cost Per MCF
(1)	(2)	(3)	(4)	(5)	(6)
System Gas Purchases From Leases in which Phillips Owns No Working Interest	333,364,465	3,009,457	336,373,922	$23,411,181	6.960¢
System Dry Gas Royalties and System Dry Gas Purchases of Outside Working Interests, Applicable to Leases in Which Phillips Owns An Interest	38,501,603	192,892	38,694,495	3,444,639	8.902¢
System Casinghead Gas Royalties and System Casinghead Gas Purchases of Outside Working Interests, Applicable to Leases in Which Phillips Own An Interest	31,377,131	1,538,662	32,915,793	3,464,405	10.525¢
Total	403,243,199	4,741,011	407,984,210	$30,320,225	7.432¢

Appendix
Docket No. G-1148 *et a*

PHILLIPS PETROLEUM COMPANY

GAS BALANCE AND ALLOCATION PERCENTAGES
YEAR 1954

Description		Distribution of Production						Residue Gas Sales From Systems			Total Jurisdictional Gas Sales (11) Col. (4) & Col. (10)
		Less: *Field Sales*									
	MCF	Non-Jurisdictional	Jurisdictional	Total Gas Gathered	Raw Gas Sales	Extraction Losses, Returned to Leases, etc.	Total	Non-Jurisdictional	Jurisdictional	
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	
Gas Produced										
Dry Gas	226,681,178									
Casinghead Gas	70,510,228									
Condensate Gas	78,499,506									

System Dry Gas Royalties and System Dry Gas Purchases of Outside Working Interests, Applicable to Leases in Which Phillips Owns An Interest	38,501,603	192,892	38,694,495	3,444,639	8.902¢
System Casinghead Gas Royalties and System Casinghead Gas Purchases of Outside Working Interests, Applicable to Leases in Which Phillips Own An Interest	31,377,131	1,538,662	32,915,793	3,464,405	10.525¢
Total	403,243,199	4,741,011	407,984,210	$30,320,225	7.432¢

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PHILLIPS PETROLEUM COMPANY

GAS BALANCE AND ALLOCATION PERCENTAGES
YEAR 1954

Description (1)	MCF (2)	Distribution of Production: Less: *Field Sales* Non-Jurisdictional (3)	Jurisdictional (4)	Total Gas Gathered (5)	Raw Gas Sales (6)	Extraction "Losses, Returned to Leases, etc. (7)	Residue Gas Sales From Systems: Total (8)	Non-Jurisdictional (9)	Jurisdictional (10)	Total Jurisdictional Gas Sales (11) Col. (4) & Col. (10)
Gas Produced										
Dry Gas	226,681,178									
Casinghead Gas	70,510,228									
Condensate Gas	78,499,506									
Total		375,690,912	31,370,014	65,159,256	279,161,642					
Per cent		100.0000	8.3500	17.3438	74.3062					
Gas Purchased										
Outside Leases	336,373,922									
Outside Interest in Phillips Leases:										
Dry Gas	38,694,495									
Condensate & Casinghead Gas	32,915,793									
Total		407,984,210			407,984,210					
Total Produced & Purchased		783,675,122	31,370,014	65,159,256	687,145,852	18,845,896	76,017,914	592,282,042	166,262,345	426,019,697	491,178,953
Per Cent								100.0000	28.0715	71.9285	
Btu per Cubic Foot					1151	1151		1063			
Total Btu (Millions)					790,904,876	21,691,626	139,617,439	629,595,811			
Per Cent					100.0000	2.7426	17.6529	79.6045			

PHILLIPS PETROLEUM COMPANY
JURISDICTIONAL COST OF SERVICE
YEAR 1954

Description	Volume	Total Cost of Gas	Distribution of Production & Exploration Costs: Field Sales Non-Jurisdictional	Field Sales Jurisdictional	Delivered to Gathering Systems	Raw Gas Sales	Balance Col. (6)-Col. (7)	Less: Liquids Extracted	Total Cost of System Sales
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Per Cent		100.0000	8.3500	17.3438	74.3062	Col. (6) × 2.7426%		Col. (8) × 17.6529%	Cols. (6)-Col. (9)
COST OF GAS PRODUCTION & EXPLORATION									
Direct and Allocated	375,690,912	$37,924,378	$3,166,686	$6,577,528	$28,180,164				
Purchased Gas	407,984,210	30,320,225			30,320,225				
Total Cost of Produced and Purchased Gas		$68,244,603			$58,500,389	$1,604,432	$56,895,957	$10,043,786	$48,456,603
Gathering System and Compressing Facilities		18,452,321			18,452,321	506,073	17,946,248	3,168,033	15,284,288
Residue System		1,674,725			1,674,725				1,674,725
Sub-total		$88,371,649			$78,627,435	$2,110,505	$74,842,205	$13,211,819	65,415,616
Raw Gas Sales						($2,110,505)			$ 2,110,505
Total									$67,526,121

Jurisdictional Sales from Systems (Column (12))
Jurisdictional Sales From Leases (Column (5))
Regulatory Commission Expense

Total Jurisdictional Cost of Service

COST PER M.C.
$55,548,054 ÷ [1]

[1] See Appendix 9

Appendix 10
Docket No. G-1148 *et al.*

PHILLIPS PETROLEUM COMPANY
JURISDICTIONAL COST OF SERVICE
YEAR 1954

Volume	Total Cost of Gas	Distribution of Production & Exploration Costs: Field Sales Non-Jurisdictional	Field Sales Jurisdictional	Delivered to Gathering Systems	Raw Gas Sales	Balance Col. (6)-Col. (7)	Less: Liquids Extracted	Total Cost of System Sales	Sales Non-Jurisdictional	Sales Jurisdictional
(2)	(3) 100.0000	(4) 8.3500	(5) 17.3438	(6) 74.3062	(7) Col. (6) × 2.7426%	(8)	(9) Col. (8) × 17.6529%	(10) Cols. (6)-Col. (9)	(11) 28.0715%	(12) 71.9285%
375,690,912	$37,924,378	$3,166,686	$6,577,528	$28,180,164						
407,984,210	30,320,225			30,320,225						
	$68,244,603			$58,500,389	$1,604,432	$56,895,957	$10,043,786	$48,456,603		
	18,452,321			18,452,321	506,073	17,946,248	3,168,033	15,284,288		
	1,674,725			1,674,725				1,674,725		
	$88,371,649			$78,627,435	$2,110,505	$74,842,205	$13,211,819	65,415,616		
					($2,110,505)			$ 2,110,505		
								$67,526,121	$18,955,595	$48,570,526

Jurisdictional Sales from Systems (Column (12))	$48,570,526
Jurisdictional Sales From Leases (Column (5))	6,577,528
Regulatory Commission Expense	400,000
Total Jurisdictional Cost of Service	$55,548,064

COST PER M.C.F.
$55,548,054 ÷ [1] 491,178,963 M.C.F. 11.309¢

[1] See Appendix 9

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Before Commissioners: Jerome K. Kuykendall, Chairman; Frederick Stueck and Arthur Kline.

Statement of General Policy No. 61-1

Establishment of Price Standards to be Applied In Determining The Acceptability of Initial Price Proposals and Increased Rate Filings by Independent Producers of Natural Gas

(Issued September 28, 1960)

This statement establishing rate standards for independent producers of natural gas is issued on our own motion and is based on our experience gained after six years of regulation of independent producers under the Natural Gas Act. By this statement and the appended area price schedules we will set standards for initial and increased rate filings by producers for the sale of natural gas into interstate commerce. These standards will serve as a guide to us and to interested parties in determining whether proposed initial rates should be certificated without a price condition and whether proposed rate changes should be accepted or suspended.

Since the Supreme Court's 1954 decision in *Phillips Petroleum Company* v. *Wisconsin*, 347 U.S. 674, holding that under the Natural Gas Act the Commission has jurisdiction over the interstate transportation and interstate sale for resale of natural gas by independent producers, and that such producers are "natural-gas companies" under the Act, the Commission's regulatory task has increased enormously in size and difficulty. In contrast to the regulation of less than 200 pipeline companies prior to the *Phillip* case, under this decision Commission regulation extends to several thousand independent producers of

natural gas. Although this producer segment of the natural gas industry differs from the pipeline transmission portion in fundamental particulars, its multiplicity of sales and services are now required to be covered by many thousands of rate and certificate filings under the Act.

This ever-growing volume of additional rate and certificate filings has placed an increasing burden not only on this Commission and other regulatory commissions, but on all those—consumers, producers, pipeline companies, and distributing companies as well—whose interests we must consider in administering the Act. It is essential, particularly in the interest of the consumer for whose protection the statute was enacted, that means be found for making the most effective use possible of the Commission's limited facilities in discharging the new and additional duties called for by the regulation of producers of natural gas. In our opinion, the price standards established by this statement will aid in effectively applying the

provisions of the Act to independent producers on a simple, clear and administratively feasible basis, and in a manner fair to all whose interests are affected by Commission regulation. Our many reasons for establishing these maximum acceptable rates as opposed to establishing rates based on a full cost-rate base hearing for every rate filing made by producers are set forth at considerable length in our opinion No. 338, *Phillips Petroleum Co.*, Docket No. G-1148, et al., pp. 5 thru 12, issued on this date.

Some further explanation is required of certain aspects of these area rate levels. The geographical areas which we have used are convenient and well known. They are not necessarily in complete accord with geographical and economic factors which may be relevant to the establishment of pricing areas. As experience and changing factors may indicate, we will change or alter these areas from time to

time in order to eliminate such inequities as may appear to exist because of our use of geographical boundaries.

In arriving at the price levels for the various areas set forth in the appendix to this statement, we have considered all of the relevant facts available to us. Such consideration included cost information from all decided and pending cases, existing and historical price structures, volumes of production, trends in production, price trends in the various areas over a number of years, trends in exploration and development, trends in demands, and the available markets for the gas. Of necessity, we have not set forth the adjustments to these prices which must be made to take into account every possible provision of every contract which may affect the actual price, such as Btu adjustments, conditions of delivery, etc. The relevance of such adjustments to the basic contract price and the appropriate established price standard must be considered as each filing is made. As it becomes apparent that certain adjustments have general applicability in a specific area, the area price standard will be revised and set forth in greater detail with regard to the exact sale conditions to which the rate applies. We should, however, make it clear that these present price standards apply to pipeline quality gas as that term is generally understood in each area and, except for the Louisiana prices, are inclusive of all taxes.

Two price standards are set for each area. Initial prices in new contracts are, and in many cases by virtue of economic factors, must be higher than the prices contained in old contracts. For this reason, we have found it advisable to adopt two schedules of prices, one pertaining to initial prices in new contracts and one pertaining to escalated prices in existing contracts. It is anticipated that these differences in price levels will be reduced and eventually eliminated as subsequent experience brings about revisions in the prices in the various areas.

It will be noted that we have omitted listing an initial price level for sales from Southern Louisiana and Mississippi. The proper initial price level for these areas is currently the subject of two hearings pursuant to Supreme Court decisions. *Atlantic Refining Co.* v. *Public Service Commission*, 360 U.S. 378; *Public Service Commission* v. *F.P.C.*, 361 U.S. 195, F.P.C.

Docket Nos. G-11024, *et al.*, and G-13143, *et al.*, respectively. Clearly, in light of these cases, it would not be proper at this time for us to announce an initial rate level for these areas prior to a final determination of these cases.

These price levels, as announced by Appendix A attached to this statement, are for the purpose of guidance and initial action by the Commission and their use will not deprive any party of substantive rights or fix the ultimate justness and reasonableness of any rate level. As with the areas, the prices will be adjusted from time to time as such facts as may come before us compel such adjustments. For the present, and in the absence of compelling evidence calling for other action by us, proposed initial sales of natural gas by independent producers which include rates higher than those indicated in the appendix attached to this statement shall be denied a certificate or certificated only upon the condition that lower rates be filed, and all rate changes filed under existing contracts which call for a rate exceeding the indicated price level in the attached appendix to this statement shall be suspended.

Where a proposed price exceeds the indicated rate level and is therefore conditioned or suspended we will, in determining whether the higher price is justified, not necessarily consider only the financial requirements of the individual producer proposing the price but will consider all of the above elements relevant to the industry generally in the area concerned. Similar evidence will also be required

from purchasers or their customers who object to any of the price levels or any specific price. Our determination will be in the nature of setting a price for the gas itself from any source questioned and not necessarily a price applicable solely to the party proposing some other price. In this connection we urge that all parties who have any interest in changing an area price join in such a proceeding leading to a determination of a proper revision, if any, in an area price or in the geographical area itself. As there will undoubtedly be numerous parties with an interest in such a proceeding full use should be made of prehearing procedures to reduce the factual issues and consolidate factual presentations to eliminate repetition and duplication of evidence. Because of the impossibility of giving detailed instructions for every proceeding, the precise course of each hearing and the admissibility and relevant weight of each type of evidence must be determined as hearings proceed and we expect to issue additional policy statements from time to time clarifying various aspects of these procedures and principles. The new area rate determinations resulting from such proceedings will represent final determinations of just rates for the areas involved as of the date of the decision and for prior periods.

By the Commission.

APPENDIX A
(To Statement of General Policy No. 61-1)

AREA PRICE LEVELS FOR NATURAL GAS SALES BY INDEPENDENT PRODUCERS

(All Rates at 14.65 PSIA)

Area	Initial Service Rates/MCF	Increased Rates/MCF
Texas		
District No. 1	15.0¢	14.0¢
District No. 2	18.0¢	14.0¢
District No. 3	18.0¢	14.0¢
District No. 4	18.0¢	14.0¢
District No. 5	14.0¢	14.0¢
District No. 6	15.0¢	14.0¢
District No. 7-b	14.0¢	11.0¢
District No. 7-c	16.0¢	11.0¢
District No. 8	16.0¢	11.0¢
District No. 9	14.0¢	14.0¢
District No. 10	17.0¢	11.0¢
Louisiana		
Southern	not determined	13.7¢ (14.0¢ at 15.025 psia)
Northern	16.6¢ (17.0¢ @ 15.025 psia)	13.7¢ (14.0¢ at 15.025 psia)
Mississippi	not determined	13.7¢ (14.0¢ at 15.025 psia)
Oklahoma		
Panhandle Area	17.0¢	11.0¢
Other	15.0¢	11.0¢
Carter-Knox	16.8¢	11.0¢
Kansas	16.0¢	11.0¢
New Mexico		
Permian Basin	16.0¢	11.0¢
San Juan Basin	12.7¢ (13.0¢ @ 15.025 psia)	12.7¢ (13.0¢ at 15.025 psia)
Colorado	14.6¢ (15.0¢ @ 15.025 psia)	12.7¢ (13.0¢ at 15.025 psia)
Wyoming	15.0¢	12.7¢ (13.0¢ at 15.025 psia)
West Virginia	26.8¢ (28.0¢ @ 15.325 psia)	23.9¢ (25.0¢ at 15.325 psia)

Application of State of Wisconsin and Public Service Commission of Wisconsin for Rehearing

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Now Comes the State of Wisconsin and Public Service Commission of Wisconsin, pursuant to the provisions of Section 19(a) of the Natural Gas Act and Section 1.34 of the Rules of Practice and Procedure of the Federal Power Commission, and for their application for rehearing from the determination of the Federal Power Commission issued on September 28, 1960 (Opinion No. 338) in the above captioned proceedings, allege as follows:

I.

That the State of Wisconsin is one of the states of the United States, and the Public Service Commission of Wisconsin is an agency of said state deriving its powers from statutes enacted by the Legislature of Wisconsin, having powers and duties given it by Chapter 195 and 196, Wisconsin Statutes, which include, among other things, the power and duties to regulate rates charged by and the adequacy of service furnished by public utilities in Wisconsin, including those which deliver

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and sell natural gas to the public for ultimate public consumption, to the end that such public utilities deliver and furnish reasonably adequate natural gas service to the public at just and reasonable rates.

Much of the natural gas sold in Wisconsin is purchased by local distribution utilities from Michigan Wisconsin Pipe Line Company, which in turn purchases up to 343,000 Mcf of natural gas from Phillips Petroleum Company at the Sherman Gasoline Plant in Hansford County, State of Texas. Phillips also sells substantial quantities of gas to Northern Natural, Permian Basin, Natural Gas Pipeline Company of America and Peoples Gulf Coast. Some of this gas is delivered to Wisconsin customers of Northern Natural and Natural Gas Pipeline Company of America.

The Public Service Commission of Wisconsin is a "state commission" within the meaning of the term as used in Sections 2(8), 13 and 15 of the Natural Gas Act and Section 1.8 of the Rules of Practice and Procedure of the Federal Power Commission.

Both the State of Wisconsin and Public Service Commission of Wisconsin represent the consuming public in Wisconsin in matters before the Federal Power Commission so as to have supplied to such consumers reasonably adequate natural gas service and facilities at just and reasonable rates.

The State of Wisconsin is also a consumer of natural gas purchased from Madison Gas & Electric Company among others, which in turn purchases said gas from Michigan Wisconsin Pipe Line Company.

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The State of Wisconsin and Public Service Commission of Wisconsin are intervenors in the above-captioned dockets and participated therein, submitting evidence and argument.

II.

For their grounds for rehearing the State of Wisconsin and Public Service Commission of Wisconsin state that the Federal Power Commission (FPC) and the members of the Federal Power Commission (FPC) who participated in the decision issued September 28, 1960 denominated Opinion No. 338, erred in issuing said opinion in each of the following respects:

(1) By including (pages 5 to 11, inclusive) statements as to policies to be followed in regulating the rates of independent producers.

The inclusion of such material is error and the same should be stricken because the issue in this case is to determine whether the jurisdictional rates and charges or classifications demanded, observed, charged or collected by Phillips, or any rules, regulations, practices or contracts affecting them, are unjust, unreasonable, unduly discriminatory or preferential. Natural Gas Act §§ 4, 5. This must be determined on the basis of the facts and circumstances disclosed by the record in this proceeding. Administrative Procedure Act §§ 7(d), 8. What might or might not be done in some other case must be determined on the basis of the record in that case.

The material at pages 5 to 11, inclusive, of Opinion No. 338 should also be stricken for the reason they are gratuitous statements not binding on the Federal Power Commission

or any member thereof in a subsequent rate-case. A rate order is not *res adjudicata* and every rate order may be superseded by another order. *Tagg Bros. & Moorhead* v. *United States*, 280 U.S. 420, 74 L. Ed. 524.

Such material is in any event unnecessary as, in any event, Opinion No. 338 purports to determine the cost

of service for Phillips on a cost basis which, as the Presiding Examiner pointed out (page 13 of Opinion), was a method urged by intervenors, the Staff and Phillips.

The Federal Power Commission also erred in saying that regulation of independent producers on the basis of costs is not feasible. See Presiding Examiner's decision pp. 12-14 for material supporting our position. In any event, cost is required as a starting point at least, by law. *Detroit* v. *Federal Power Comm.*, 230 F. (2d) 810; *Episcopal T.S.* v. *Federal Power Comm.*, 269 F. (2d) 228. The Federal Power Commission misinterprets and misconstrues *Forest Oil Corporation* v. *Federal Power Comm.*, 263 F. (2d) 622, which when properly read clearly in accord with *Bel Oil Corp.* v. *Federal Power Comm.*, 255 F. (2d) 548, which in turn does not lay down a different rule than *Detroit* v. *Federal Power Comm., supra.*

The so-called "policy statement" (page 11) is in excess of the statutory powers of the Federal Power Commission. Legally it is a mere *ex parte* statement by members of the Federal Power Commission based on no record and made without opportunity for petitioners or any other party to be heard. The figures selected are arbitrary and capricious and represent

administrative fiat. Said policy statement has no evidentiary suport in the record in this case, and cannot legally be made in this case because it is beyond the issues in this case. It cannot be considered as a rule because the Federal Power Commission has not complied with the statutory requirements for rule making. Administrative Procedure Act § 4.

As a practical matter, however, such statement will raise producer prices in areas where they operate, up to the maximum price stated, and hence will create a "price plateau" for natural gas in the areas involved without any

consideration being given as to the cost to the various producers therein and will constitute a change in rate without complying with Sections 4, 5 of the Natural Gas Act. This would be prejudicial to the consumers of natural gas. Cf. *Atlantic Refining Co.* v. *Public Serv. Comm. of New York*, 360 U.S. 378, 3 L. Ed. (2d) 1312.

(2) By concluding the increased cost of gas purportedly called for under percentage type casinghead contracts between Phillips and its suppliers is proper, although no dollar amount for such item is determined. Opinion No. 338, pp. 15-17.

The allowance of this or any other dollar amount for this item is error because the said gas suppliers are each a "natural gas company" (*Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672) subject to regulation by the Federal Power Commission, and said increase constitutes a change in rate under Section 4(d), Natural Gas Act, and can be made only after compliance therewith and approval of the Federal Power Commission, and is also subject to Section 5 of the Act.

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Bel Oil Corp. v. *Federal Power Comm.*, 255 F. (2d) 548, 554; *Episcopal T.S.* v. *Federal Power Comm.*, 269 F. (2d) 228, 231-2, 235.

The Federal Power Commission cannot avoid statutory requirements by adoption of a rule such as Section 154.91(e). The case of *Sun Oil Co.* v. *Federal Power Comm.*, 256 F. (2d) 233, is not applicable. Among other things, there no injury had been shown. Allowance of such an increase as here proposed without meeting the standards of Sections 4 and 5 of the Act would injure consumers.

(3) By reducing interest deduction for tax purposes from $9,892,308 (actual recorded company-wide interest

expense for 1954) to $3,743,077, which latter amount becomes $1,895,730 when allocated to the Natural Gas Department and Oil and Gas Production Department. Pages 17, 18.

(4) By including in the estimate for joint production expenses (exclusive of exploration) the amount of $18,726,572 for return and tax incentives, as set forth in Appendix 5. Page 19.

The Federal Power Commission erred in allowing the $18,726,572 representing return and tax incentive, based on a return allowance of 11% which, for reasons stated in (10), *infra*, is in excess of a proper rate of return, which should not exceed 9.16% (based on 2.76% cost of debt and 10% for common equity) and on basis of A. R. Colbert testimony and exhibit, 7¾%. See paragraph (9), *infra*.

(5) By including in exploration and development costs

the amount of $10,839,194 for return and taxes. Page 23.

The Federal Power Commission erred in allowing $10,839,194 for return and taxes. The return allowance used is 11% (Appendix 1), which is an erroneous rate of return for reasons stated in (9), *infra*.

(6) By allocating exploration and development costs on the basis of the Btu. content of gas and oil to which an "economic factor" of 4 is applied to the Btu. content of a barrel of oil (42 gallons) so that it is considered the cost relationship of finding 1 Mcf of gas to 1 barrel of oil will be 1 to 24. Page 29.

The Federal Power Commission erred in adopting such method of allocation because the record contains no evidence which supports use of a so-called "economic factor" of 4. This is recognized by the Federal Power Commission (p. 29) when it states its result is based on an exercise of "administrative judgment" based on the record but that

the record did not lead us to the precise conclusion. Additionally the FPC in utilizing a 4 to 1 economic weighting factor, in effect, created a new pricing relationship between gas and oil which is not based on any facts of record or any thing more than a desire to further enhance the gas production end of the joint oil and gas business at an expense of the gas consuming public.

If this factor is eliminated (as it must be because there is no evidence supporting its use—Administrative Procedure Act § 7(c)), any allocation based on the Btu. content

of the fuels must be rejected because of the difference in form and methods of utilization between the two fuels. (Pettyjohn, Tr. 95:12652 to 95:12706, and Exhibits 348 to 352.)

(7) By adopting a year-end rate base. Page 36.

The Federal Power Commission erred in the above respect because it weighs in for a full year the cost of plant additions made for such year, whereas revenues and expenses against which the investment has been matched are not adjusted as to reflect the operation of facilities installed on a full year basis. Van Scoyoc, Tr. 101:13370. The proper method is to use an average year rate base and thus match rate base with revenues and expenses. Use of a year-end rate base produces additional return.

(8) By including in rate base $8,430,758 representing net investment in San Juan producing leases which were transferred to Pacific Northwest Pipe Line Corporation in November 1955. Page 36-7.

The Federal Power Commission erred in the above respect because even under regulation on a going-concern basis there have been and will continue to be in the future other "San Juan situations." The immediate reimbursement of the investment and the continuing overriding

royalties are considered nonoperating revenues. Under cost regulation customers are required to carry the burden of all costs associated with jurisdictional revenues. Certainly it would be basically unfair to set jurisdictional revenues at a level which would require a continuing return on property already sold and from which the continuing overriding royalties were absorbed as nonjurisdictional

revenues. The inherent unfairness of such an arrangement speaks for itself. The San Juan properties should be summarily excluded from the rate base. Substituted property should be included only when specifically denominated and identified.

Here the Federal Power Commission does not purport to proceed on the going-concern basis, since it states (p. 30) it is not determining rates for the future, and in one instance (p. 17) refused to make an adjustment because it said it was not determining future rates. Under such circumstances this is all the more reason why the amount representing the San Juan leases should not be included in the rate base.

Further, the Federal Power Commission stated (p. 17) it makes adjustments in the actual test year data for known changes after the end of the test year, and did so in one instance (pages 17, 18). If the Federal Power Commission is going to make adjustments of known changes after the end of the test year in favor of Phillips, it should also make an adjustment for the San Juan item which goes the other way, or at least give credit for normal revenues which could be expected from such or equivalent properties.

(9) By allowing Phillips a rate of return of 11%. Pages 39-48, inclusive.

The Federal Power Commission erred:

a. In confusing the physical risk of producing gas with the financial risk assumed by investors. (P. 42) There is a physical risk in discovering and producing gas, but it is compensated for by the allowance of the cost of exploration development and production as an expense to Phillips in deter-

mining its cost of service. This eliminates this item as a part of the financial risk, assuming that Phillips can sell its gas, and in this respect it stands in no different position than a pipeline transmission company or local distribution company. Colbert, Tr. 98:12966-7. Thus, the Federal Power Commission erred in stating (p. 42) "Nevertheless, production of gas creates risk in spite of the willingness of investors to purchase the securities of producers, and this risk must be taken into consideration in arriving at a fair rate of return. We should not base our findings wholly upon a passing tendency of investors." The Federal Power Commission erred because the actual conduct of investors, as demonstrated by earnings price ratios, shows their evaluation of the *financial* risk, including the physical risk of discovery and producing gas as well as all other risks and factors affecting the value of the stock. Tr. 112:14912. Contrary to the suggestions appearing at page 43 second paragraph, the earnings price ratios do reflect *all* factors affecting a security, plus or minus, which motivate an investor, since these factors directly reflect the price the investor is willing to pay for the common stock or other security of any company. Smith, Tr. 83:11210-11. Phillips' stock is listed on the New York Stock Exchange and this is true so far as its common stock is concerned.

b. In refusing to consider the amount of $19,162,355 (deferred Federal income tax liability under Section 168, I.R.C.) as an interest-free loan so as to reduce the cost of debt capital to 2.76%. Page 43. There can be no quarrel

with the proposition that this is interest-free capital. It comes

from money collected from rate payers. It is unfair to permit Phillips to exact higher rates from customers on capital contributed by customers at no cost to Phillips.

c. In increasing the cost of equity capital from 10%, which the Federal Power Commission indicated would be reached by earnings price ratios (pp. 46-7), by an additional 2% as an alleged incentive for the continued exploration and production of gas. This can be done only if the record shows that the amount allowed is needed for such purpose and is no more than needed. *Detroit* v. *Federal Power Comm.*, 230 F. (2d) 810. The record here contains no such evidence.

d. For the above reasons the Federal Power Commission erred in concluding (p. 48) an allowance of 12% for common equity would be fair and reasonable.

e. The proper allowance should not exceed 9.16% (based on 2.76% cost of debt and 10% for common equity) and on basis of testimony of A. R. Colbert (Tr. 98:12948-12973; 112:14871; 112.14876-14959; 112:14960 and Exhibit 369) should not exceed 7¾%.

(10) By determining the cost of service for Phillips, on the basis of a 1954 test year, to be $55,548,054 subject to adjustment for Phillips' purchased gas costs, royalties and gathering taxes. P. 49.

The figure obtained by the FPC as representing Phillips' cost of service on the basis of a 1954 test year, is affected by the errors previously noted. Elimination of such errors will reduce the cost of service below that determined by the FPC.

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(11) By (a) not holding the spiral escalation clauses in the contracts between Phillips and Michigan Wisconsin Pipe Line Company, El Paso Natural Gas Company and Panhandle Eastern Pipe Line Company void as a matter of law, and (b) in concluding that such clauses provide contractual consent to rate increases under the doctrine of *United Gas Company* v. *Mobile Gas Corporation*, 350 U.S. 332. Pages 52-3.

The Federal Power Commission erred in not holding the aforesaid spiral escalation clauses void as a matter of law, because said clauses purport to authorize increases in rates under circumstances inconsistent with the provisions of the Natural Gas Act, in that they would purport to effect a change in rate between Phillips and its pipeline customers without compliance with Sections 4 or 5 of the Natural Gas Act. The decision of the Federal Power Commission in *Re Michigan Wisconsin Pipe Line Company*, G-1678, G-1996, Opinion No. 275, mimeographed edition pp. 39-40, to the effect that the spiral escalation clause in the contract between Phillips and Michigan-Wisconsin is inconsistent with the Natural Gas Act and contrary to the public interest as a matter of law, should be followed and the Federal Power Commission erred in not doing so. Any clause (such as a spiral escalation clause) in a contract which purports to operate contrary to a statute is void as a matter of law. 12 *Am. Jur.* (Contracts) § 158, *et seq.* Nothing in *United Gas Pipe Line Co.* v. *Memphis L.G. & W.D.*, 358 U.S. 103, 3 L. Ed. (2d) 153, is to the contrary. To conclude, as does the Federal Power Commission, that a spiral escalation

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clause can constitute a consent under Section 4 of the Natural Gas Act, is tantamount to saying that a contract provision (which legally can have no effect because any rate increase purportedly called for thereby is subject to com-

pliance with, justification under and approval of the Federal Power Commission under the Natural Gas Act) constitutes a consent to a change in rates in the manner authorized by statute. There is no language in such clause that justifies the conclusion that such consent has been given, and further since such clauses are standing alone legally inoperable since enactment of the Natural Gas Act (*Bel Oil Corp. v. Federal Power Comm.* (C.A. 5), 255 F. (2d) 548, 554) and do not of themselves constitute proof establishing the right to any increase purportedly called for thereunder, they cannot legally be considered as affording a consent. See, *Episcopal T.S.* v. *Federal Power Comm.* (U.S.App.D.C.), 269 F. (2d) 228, at 235.

(12) By issuing an order that did not confine itself to any thing more than terminating proceedings in dockets where the rate in force or proposed did not exceed the cost of service as properly determined. Pages 50-56.

The Federal Power Commission erred in ordering that the proceedings in the various dockets involved be terminated, with the exception of dockets G-111217 and G-10883 which were made the subject of special orders in paragraphs (B) and (C), and in discharging the obligation of Phillips to refund excess charges respecting the dockets which were terminated.

There are certain dockets (G-3175, G-4333, G-6621,

G-8695, G-8883, G-10359, G-11125) at least where the rate under inquiry exceeded the cost of service even as computed by the Federal Power Commission. We submit the Federal Power Commission erred in not confining its order terminating proceedings to those dockets where the cost of service (after giving effect to the matters herein stated in this petition for rehearing) exceeded the cost of service (11.039¢ Mcf even on basis of the Federal Power Commission determination which we say is high). The necessary

assumption made in terminating the proceedings in dockets where the rate under inquiry exceeded the cost of service, is that the amount of any excess is offset by subsequent increase in cost so that at a subsequent time rates which exceed the cost of service as determined thereafter will be justified. We submit the Federal Power Commission erred in making and acting on such an assumption, because in so doing it (a)necessarily goes beyond the record in this case contrary to the Administrative Procedure Act § 7(c), as is shown by statements at page 51, (b) permits higher rates to become effective without showing that they are justified, adopting in effect the same procedure as was attempted in *Re Shamrock Oil and Gas Corp.*, 31 PUR (3d) 84, which procedure we assert is erroneous and which case is on review in the United States Court of Appeals for the District of Columbia Circuit, which has the effect of placing pipeline customers and consumers in the position of being faced with increases which have not been justified on any thing other than administrative fiat, consisting of (p. 54) "the area pricing standards announced at this time." Such standards are without legal effect, are based on

no record, and were promulgated without giving any one an opportunity to be heard. The Federal Power Commission recognizes (p. 51) this will leave in effect Phillips' "contract structure," thus indicating acceptance of contract prices, which is an abdication of regulation by the Federal Power Commission. Also contract prices are not sufficient to justify a change in rate. *Episcopal T.S.* v. *Federal Power Comm.* (U.S.App.D.C.), 269 F.(2d) 228, 235, *et seq.*

WHEREFORE, the State of Wisconsin and Public Service Commission of Wisconsin request that this application for rehearing be granted and that the Federal Power Com-

mission correct its Opinion No. 338 in the respects above stated.

Respectfully submitted,

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October 24, 1960.

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Petition for Rehearing on Behalf of the People of the State of California and Public Utilities Commission of the State of California

Come now the People of the State of California and the Public Utilities Commission of the State of California (California), interveners herein, and being aggrieved by the Opinion and Order Determining Cost of Service and Terminating Proceedings (Opinion No. 338) issued by the Federal Power Commission (Commission) in the above-entitled proceedings on September 28, 1960, hereby apply for rehearing and stay of said Opinion and Order pursuant to the provisions of Section 19(a) of the Natural Gas Act (Act of June 21, 1938, c. 556; 52 Stat. 821, 831; 15 USC § 717r) and pursuant to Section 1.34 of the Commission's Rules of Practice and Procedure.

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INTRODUCTION

California takes no position at this time regarding the opinions expressed by the Commission in Opinion No. 338 under the title "Regulation of Natural Gas Producers' Prices" (mimeo., pp. 5-12) wherein the Commission announces its conviction that regulation of such prices under the cost of service method is unworkable and productive of ridiculous results and wherein the Commission announces its intention to regulate producer prices hereafter by use of an area pricing method as is more particularly described in the Commission's Statement of General Policy No. 61-1 issued on the same date as it issued its opinion in the instant proceedings. Because the Commission employed the

traditional cost of service method in reaching its findings and conclusions in the instant proceedings (mimeo., p. 13) its comments concerning the future course of producer rate regulation are therefore not material here. California reserves the right, however, to challenge such comments as are contained in that portion of Opinion No. 338 indicated above as well as the Statement of General Policy No. 61-1 in any future proceeding wherein the Commission's views therein expressed may be material to its determination of rates under the Natural Gas Act.

The following grounds for rehearing and specifications of error are made in support of this petition.

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I. In terminating the Section 5(a) investigation in Docket No. 1148, the Commission failed to make a determination that the rates of Phillips Petroleum Company (Phillips) are just and reasonable as it is required to do by said section of the Natural Gas Act.

The Commission states (mimeo., pp. 50-51):

> "Having determined Phillips' cost of service, the next step would ordinarily be to alter Phillips' rates to reflect this cost of service. We are authorized in an investigation under Section 5(a) to determine rates prospectively * * *.
>
> * * * * * *

"The present proceeding involves an investigation of Phillips' rates on the basis of a record including evidence on the alternate test years 1954 and 1956 of which we chose 1954 in accordance with the decision of the examiner. *From our knowledge of the industry, it is clear enough that costs and prices of gas in the field have greatly increased since that time.* * * * Therefore we do not deem it appropriate to prescribe or require that Phillips file rates for the future based upon the present record. * * *

"As a result we shall terminate the rate investigation proceedings in Docket No. G-1148 under Section 5(a). Phillips' customers will not be substantially injured, for Phillips' rate filings have been subject to our continuing surveillance and many large increases filed by it have been suspended under Section 4(e) of the Act and are currently the subject of proceedings before us. * * *" (Emphasis supplied.)

Inasmuch as a Section 5(a) investigation is the only means provided by the Natural Gas Act for review by the Commission of initial certificated prices, the Commission's action in terminating the Section 5(a) investigation in this proceeding

may be tantamount to a conclusion that such initial prices are reasonable. However, the Commission makes no finding whatsoever that such initial prices are just and reasonable as required by Section 5(a) of the Act.

In lieu of such a finding, the Commission merely refers to its opinion based on its "knowledge of the industry" that both "costs and prices of gas in the field have greatly increased" since 1954. In basing its decision to terminate the Section 5(a) investigation on such an opinion, for which the Commission itself claims no support in the record, the

Commission has failed to make any finding based on evidence of record that initial certificated prices since 1954 are just and reasonable.[1]

The Commission points out that consumers will not be "substantially injured" because Phillips' rate filings have been subject to the Commission's "continuing surveillance". However, the very surveillance to which the Commission alludes, as far as initial prices are concerned, is to be found only within the framework of a Section 5(a) investigation. It is

such an investigation and such a surveillance that the Commission has determined to terminate by its order contained in Opinion No. 338.

Under these circumstances, consumers are not afforded any relief from unreasonable initial prices. Moreover, initial certificated prices are not subject to refund as are rate increase filings which are subject to the provisions of Section 4(e) of the Act. In this connection we think the following language from the Supreme Court's opinion in the CATCO case.[2] is pertinent.

> ". . . the delay incident to determination in § 5 proceedings through which initial certificated rates are reviewable appears nigh interminable. Although *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672, 98 L.Ed. 1035, 74 S. Ct. 794, was decided in 1954, cases instituted under § 5 are still in the investigative stage. This long delay, without the protection of refund, as is possible in a § 4 proceeding, would provide a windfall for the

[1] Compare the Commission's statement that the rates involved in the Section 4(e) proceedings, which are also terminated, "have produced revenues less than Phillips' cost of service during the periods that they were in effect." (Mimeo., p. 51.) The Commission makes no such claim relative to the rates which were reviewable only in the Section 5(a) proceeding.

[2] *Atlantic Refining Co.* v. *Public Service Commission of the State of New York*, 360 U. S. 378, 389 79 S. Ct 1246, 3 L.Ed. 2d 1312 (1959).

natural gas company with a consequent squall for the consumers. *This the Congress did not intend.*" [Emphasis supplied.]

The Commission also points out that "consumers will receive the protection of our area pricing standards announced at this time". Even so, it is inescapable that in terminating the Section 5(a) investigation, the Commission has failed to

fix just and reasonable rates for Phillips as it has the duty to do under that section of the Natural Gas Act.

II. The Commission erred in failing to find that the spiral escalation clauses in Phillips' contracts are "so derogatory of the public interest as to be void as a matter of law." (Mimeo., p. 22.)

Spiral escalation clauses, as well as favored nation clauses, result in rate increases conditioned on a fortuitous event which does not bear any relationship whatsoever to an increase in the producer's costs. California contends that no rate may be found to be just and reasonable within the meaning of Section 4(a) of the Natural Gas Act if that rate does not bear a reasonable relationship to costs. Consequently rate increase filings predicated on spiral escalation clauses in gas sales contracts *are* so derogatory of the public interest expressed in the Natural Gas Act as to be void as a matter of law.

It would appear that, at least in a sense, the Commission agrees. It states: "* * * we do not approve of such clauses in principle."[3]

[3] Mimeo., p. 22. Although the Commission does not specify the "principle" that it has in mind, the time honored regulatory principle that rates must bear a reasonable relationship to costs immediately suggests itself.

The Commission, however, is apparently dissuaded from holding such clauses to be void as a matter of law owing to its interpretation of the opinion of the Supreme Court of the United States in *United Gas Pipe Line Co.* v. *Memphis Light, Gas & Water Division,* 358 U.S. 103, 79 S.Ct. 194, 3 L.Ed. 2d 132 (1958), as well as the opinions of the United States Court of Appeals for the Tenth Circuit in *Phillips Petroleum Co.* v. *Federal Power Commission,* 227 F.2d 470 (1955) and *Kerr-McGee Oil Industries, Inc.* v. *Federal Power Commission,* 260 F.2d 602 (1958). We point out that in none of these cases was a question raised as to the validity, *on public policy grounds,* of contract clauses containing escalation features based on fortuitous events.

In *Memphis,* the Court held that a natural gas company could file a rate increase unilaterally if its customer had consented to such action. The court did not deal with the question of the reasonableness of such a rate increase under the Natural Gas Act; that was a matter for the Commission in the exercise of its regulatory jurisdiction under the Act. *Memphis* should be distinguished from a case involving a spiral escalation clause. In a *Memphis* situation, there is no reason to believe one way or another that the increase sought does not bear a reasonable relationship to costs. In the case of spiral escalation clauses, however, the very nature of the

clause indicates that the rate increase sought is not dependent upon an increase in costs but is merely dependent upon a fortuitous event—an increase in some other contract price.

As for the Tenth Circuit cases referred to by the Commission, the matter to be determined was the so-called "frozen" price under the contracts there involved as of

June 7, 1954, the date when regulation of producer prices by the Commission commenced. The court's resolution of the problem was based entirely upon principles of private contract law unfettered by any consideration of regulatory standards; it was the price *before regulation* that was at issue.

Thus there was no occasion in these cases to reach or to decide the question as to whether spiral escalation clauses are void as a matter of law. In the present proceedings, however, the Commission must consider spiral escalation clauses in terms of their effect on rates which are subject to the regulatory standards of the Natural Gas Act. This it has failed to do, addressing itself only to the question of the existence of customer consent to the pricing scheme contained in the spiral escalation clauses.

California contends that spiral escalations clauses are not geared to increases in costs and are therefore so derogatory of the public interest as to be void as a matter of law. In failing to so find, the Commission erred.

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CONCLUSION

On the grounds set forth herein petitioners, the People of the State of California and the Public Utilities Commission of the State of California, respectfully apply for rehearing in the instant proceedings and request that the order contained in Opinion No. 338, Opinion and Order

Determining Cost of Service and Terminating Proceedings, issued September 28, 1960, be stayed.

Respectfully submitted,

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Dated: October 26, 1960.

Application of the Eastern Seaboard Companies for Rehearing

I.

Position of Eastern Seaboard Companies [1]

It is the position of the Eastern Seaboard Companies, as set forth in this Application for Rehearing, that the Commission, in its Opinion No. 338 and Order issued herein on September 28, 1960, erred in failing to "fix the rates at which [Phillips' jurisdictional] . . . sales are made," as required by the opinion rendered in this proceeding by the United States Court of Appeals for the District of Columbia Circuit, *State of Wisconsin* v. *FPC*, 205 F. 2d 706, 712 (1953); affirmed 347 U.S. 672 (1954).

The Commission has a responsibility under the Natural Gas Act to determine and make proper findings as to the validity of Phillips' rates for all its jurisdictional gas sales. Moreover, and as pointed out above, the Courts have directed it to do so. In issuing Opinion No. 338, the Commission has taken the first and most difficult step toward accomplishing this goal by developing methods of ascertaining Phillips'

financial requirements. But the full responsibility imposed upon the Commission has not yet been met. Having found a cost of service applicable to Phillips' jurisdictional business and having the power to require submission of any necessary additional data, the Commission is under a clear duty to fix rates at which Phillips may make jurisdictional

[1] As used in this application, the term "Eastern Seaboard Companies" designates Long Island Lighting Company, Philadelphia Electric Company and The United Gas Improvement Company.

sales. Its failure to perform such duty is erroneous as a matter of law and constitutes a judicially-reversible abuse of discretion.[2]

The Commission should consolidate with G-1148 all of Phillips' pending Section 4(e) filings, should set such consolidated docket down for prompt hearing and should direct Phillips to submit a schedule of rates designed to recover its 1959 costs, determined in accordance with the practices established by the Commission in Opinion No. 338. The resolution of the issues posed by this proceeding, so sorely needed, can most expeditiously be achieved by such a course —not by ignoring current costs as well as current revenues and leaving the determination of the proper level of Phillips' rates to some unspecified time in the future.[3]

II.

The Commission Abused Its Discretion By Terminating These Proceedings Before Fixing Phillips' Rates For The Future.

The Commission's Opinion and Order herein contain no findings that Phillips' rates are "just and reasonable", that they are not "unduly discriminatory" or that they are "non-preferential". Rather, the Commission, finding that Phillips' 1954 revenues did not exceed its 1954 cost of service, terminated the Section 5(a) investigation and the consolidated Section 4(e) proceedings. This action constitutes an

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[2] In view of the Commission's use in this case of a cost-of-service basis for ascertaining jurisdictional revenues to which Phillips was entitled in the test year, the Eastern Seaboard Companies do not deal here with any of the Commission's comments concerning the cost-of-service method of regulation, appropriate allocation methods, alternative methods of producer regulation, or other theories not discussed in this application. Petitioners reserve the right however, to challenge any or all of these comments or conclusions in any proceeding where they have a direct bearing on rate levels.

[3] Involved are as many as 95 unconsolidated rate increase proceedings amounting to some $22 million annually. See Appendix C.

abuse of discretion in the circumstances of this case because (1) it conflicts with the basic policies of the Natural Gas Act as enunciated by the Supreme Court in *Hope, Colorado Interstate, Phillips* and CATCO, and (2) it ignores the Commission's responsibilities under

the Act as the Commission itself has so often recognized th m in terms of protecting consumers.

Section 4(a), 4(e) and 5(a) of the Act contemplates that the Commission will establish rates for natural gas companies which meet the standards prescribed by those sections. The Act, it is true, gives the Commission a certain amount of discretion in suspending rate increases or initiating rate investigations. This discretion is, however, bounded by the over-riding rate policies of the Act. The Commission cannot exercise its discretion in a way which conflicts with or negates basic Congressional policy. *Office Employees Int'l Union* v. *NLRB*, 353 U.S. 313, 316-320 (1957); *Schaffer Transportation Co.* v. *United States*, 355 U.S. 83, 88, 93-94 (1957).

Phillips' Section 5(a) investigation was reinstated in November, 1954, following the Supreme Court's *Phillips* decision, and a number of Section 4(e) rate increases were consolidated therewith for hearing. However, at various times since November, 1954, Phillips has filed not only additional, unconsolidated rate increases aggregating some $22 million in annual amount (which are effective subject to refund) but also a large number of new rate schedules, at rates far exceeding its unit cost, which have been certificated by the Commission without *any* inquiry into the level of the rates involved.

As a consequence, Phillips rate schedules now in effect generate revenues which are substantially greater than either its cost of service, as determined by the Commission in this proceeding, or its 1954 revenues. While Phillips

has a total of roughly 370 rate schedules now on file, Phillips' principal rate schedules number only about 130 (i.e., excluding casinghead-type and "de minimis" contracts). The filed rates as of September 28, 1960 included in 57 [4] of these principal rate schedules are subject to Section 4(e) proceedings, and to some extent to refund. Of the remaining 74, 70 [5] will not be subject to any rate "surveillance" if Phillips' Section 5(a) investigation is terminated. Of these 70 rates not subject to a Section 4 proceeding, 40 exceed the area rate standards for old gas announced by the Commission in its Statement of General Policy 61-1, which applies to gas sales certificated before September 28, 1960 and 6 exceed the price for new sales in that Statement (50 also exceed Phillips' unit cost of service) (Appendix A, *infra*).

[4] Four of these are involved in suspension proceedings due solely to change in tax reimbursement.

[5] Four contracts are unavailable.

A. Phillips' Current Revenues From "Old" Sales[6] Far Exceed Its Adjusted 1954 Cost of Service.

Appendix A hereto shows that, if Phillips' major sales in 1954 were made in the same volumes but were priced at the rates now in effect, its revenues would be increased by some $23 million a year and would total almost $62 million, or about $6.5 million more than Phillips' entire cost of service.[7] (This does not include the revenues from so-called *de minimis* and casinghead contracts, which would add about $1,463,000 a year (based on 1958 rate levels) nor does it include revenues from *new* sales i.e., sales made under post-1954 contracts, now being made by Phillips.) The current unit revenue from these "old" sales averages about 13.8 cents per Mcf, or substantially greater than Phillips' unit costs in 1954 (which the Commission found virtually unchanged as late as 1956, mimeo, p. 14). This very material increase results from the fact that the 1954 rates contained in 36 of Phillips' 48 principal rate schedules in effect during 1954 (as enumerated in Appendix A) are now superceded by substantially higher rates, the lawfulness of which was not passed upon by the Commission in Opinion No. 338. All such rate schedules in fact show an increase.

Additionally, Phillips' offer of settlement submitted in April 1960 and discussed in the Commission's Opinion, indicated that, without regard to new sales, Phillips would collect average revenues of about 14.4 cents per Mcf—even further above what the Commission has determined to be the company's unit costs, including a fair return.

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[6] I.e., contracts under which sales were being made in 1954 and are still being made in 1960.

[7] Since the Commission, for some unknown reason, has not required Phillips to file in 1960 the Form 301 report required by the Commission's Regulations, data relating to Phillips' 1959 revenues and costs, which would be revealed by that report are not available either to the Commission or the parties hereto.

These increases in Phillips' present levels of revenues for "old" sales have been ignored by the Commission, except for its promise to exercise "continuing surveillance" in pending non-consolidated Section 4(e) proceedings, and its announcement of area pricing standards which it might apply, in some unspecified way, at some indefinite time in the future (see dissenting opinion).

For example, one of the rate suspension proceedings terminated by the Commission Order, Docket No. G-4333, involves a sale to Transcontinental Gas Pipe Line Corporation (Transco) from the Tigre Lagoon Field, Vermilion Parish, Louisiana. The initial rate

for this sale was 8.5 cents per Mcf at 16.7 psia. This price escalated under a favored nation clause to 16 cents per Mcf, (at 15.025 psia) on February 25, 1955, plus 1 cent tax reimbursement. The rate now being collected for this sale, 23.55 cents per Mcf, has been in effect since July 9, 1959,[8] as a result of a favored nation filing arising out of the Commission's *Transco-Seaboard* order.[9] This 23.55 cent rate is being collected even though the validity of the triggering event—i.e., the new purchases by Transco—is still pending before the Commission on remand; and despite the Commission's pledge in its *Transco-Seaboard* order (Opinion No. 315, mimeo, p. 10) that petitioners would be protected against the triggering effect of that order:

> Second, UGI and the New York Commission contend that on the facts the examiner erred in concluding that there was no substantial evidence of harm to the public from the certification of these producers' sales at the prices proposed. They argue that triggering would increase the price of gas purchased by Transco and ulti-

[8] Pursuant to an order entered July 17, 1959 in Docket No. G-17[illegible].

[9] In the Matter of *Transcontinental Gas Pipe Line Corp., et al.*, Opinion No. 315, Issued September 4, 1958; 20 FPC 264.

mately the consumer by as much as $5,000,000 a year. The fact is, however, that before any such "triggered" increases could be passed along, filings for increased rates would have to be made by the producers and these would be subject to our scrutiny and control under the rate suspension provisions of Section 4 of the Act.[10]

The Commission has an obligation not merely to suspend Phillips' presumptively unlawful rate increases, but also promptly to determine the lawfulness of all of Phillips' untested rates under Section 5(a) and 4(e) of the Act.

Accordingly, it is required to determine the lawfulness of the interim Tigre Lagoon 17¢ per Mcf rate in conjunction with all of Phillips' other rates, which it cannot do merely by terminating the existing Section 5(a) proceeding. Furthermore, the Commission abused its discretion by failing to "scrutinize and control" the Tigre Lagoon rate increase to 23.55 per Mcf, as it assured the consumer it would do. It similarly erred with respect to the approximately 94 other pending but unconsolidated rate increases (Opinion No. 338, mimeo, p. 50) with refund periods running from various dates since April, 1957 (Appendix C, *infra*).[11]

[10] Note 9, *supra* at 274.

[11] "The Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible." Natural Gas Act, § 4(e), 15 USC § 717c(e) (1958).

B. Phillips' Revenues Under "New" Sales Are Also Substantially in Excess of Costs.

Phillips' rate schedules for "new" sales [12] will generate revenues of about $25 million annually, averaging about 19 cents per Mcf, or more than half again as much as the Commission's determination of Phillips' average unit costs in 1954.

A substantial number (approximately 55)[13] of these "new" sales are currently being made under rates no part of which are subject to refund for any period and which are among the highest filed rates now in effect. According to the billing data submitted in the rate schedules, even these new rates alone will generate average unit revenues of about 18¢ per Mcf, far above *Phillips'* cost of service in its adjusted test year. All but 16 of these sales exceed the Commission's lower area rate standard for gas sales, and 6 exceed the Commission's standard for initial sales. (Appendix B).

Thus, there can be very little doubt that Phillips' current revenues substantially exceed its cost of service. Despite this strong evidence that Phillips' current rates are unlawful, the Commission has terminated its Section 5(a) investigation.

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[12] I.e. rate schedules shown in Appendix B, starting at No. 273 and extending through rate schedule 371, not included in G-1148 exhibits or considered there. This Appendix also lists the Commission's announced area rate standards, for old and new sales, shows indicated revenues, the docket numbers of Section 4 proceedings involving such sales and the current status of the sales under Section 7.

[13] Complete figures are unobtainable, since it is impossible to determine in some cases from the Commission's public records the present certified status of Phillip's sales. Most of these initial sales were certificated by the Commission before the Supreme Court's CATCO decision at a time when the Commission was under a misapprehension as to the "most careful scrutiny" of initial prices required in producer certificate cases. In several cases, certificates were issued after uncontested hearings.

III.

There Is No Record Support For The Commission's Assumption That General Industry Cost Increases Justify Dismissal Of Phillips' Section 5(a) Proceeding.

The Commission's sole attempt to justify its failure to complete the "nigh interminable" Phillips' rates investigation by determining "just and reasonable" rates for its current and future sales, is found in its comment that Phillips' higher current rates are "probably" reasonable through 1958 because its costs have increased. Thus, the Commission inferentially recognizes that Phillips' revenues in all probability exceed its costs at least in 1959 and later years. In any case, there is absolutely no evidence of record establishing that Phillips'

cost have increased from 1954 through 1958, and the Commission has not used the methods readily available for ascertaining this fact.

The Commission's failure to do so is particularly unfortunate, since Phillips' higher rates do not necessarily reflect cost increases but rather are the result of fixed price escalations, or favored nation, spiral, or other formulative price redeterminations. Accordingly, while the Commission may properly infer higher "prices of gas in the field" from the higher rates, it may not legitimately infer higher costs.

The Commission suggests that the consumer will not be injured by the termination of this proceeding because Phillips' higher initial rates are still subject (prospectively only) to the Commission's proposed area price program (mimeo., p. 51).[14] But the Commission program, as its

[14] The Commission's argument (mimeo., p. 51) that Phillips' current *increased* rates involved in Section 4(e) proceedings are still subject to refund overlooks the fact that the Commission later in its Opinion (mimeo., p. 53) states that it intends to terminate all of Phillips' suspension proceedings involving rates filed prior to 1959.

Opinion recognizes, is still in embryo, so that when, if ever, the consumer will obtain even mere *prospective* relief from Phillips' new higher rates is problematical.

The Commission has told the Federal courts repeatedly in recent cases involving its rate procedures that Section 5(a) proceedings, such as that in Phillips, would provide more than adequate consumer protection against excessive initial producer prices.

See, as examples, briefs for the Federal Power Commission in:

Atlantic Refining Co. v. *P.S.C. of New York,* Sup. Ct., October Term 1958, No. 518, pp. 100-101.

Oklahoma Natural Gas Co. v. *FPC,* CADC, No. 13783, pp. 15, 28.

The United Gas Improvement Co. v. *FPC,* Nos. 12797 and 12805, pp. 49-59.

The United Gas Improvement Co. v. *FPC,* CA 9, No. 16692, pp. 28-29.

These repeated representations by the Commission to the Federal courts make it difficult to understand its termination of an *existing* Section 5(a) proceeding in the face of *existing* untested initial prices at levels far exceeding the prices approved in this proceeding. Certainly, the Commission's purported awareness, *dehors* this record,

that producer costs have in general increased some indefinite amount from 1954 through 1958 does not support the lawfulness of the particular high initial prices being collected by Phillips in 1959. Especially is this so in view of the fact that the Commission's Opinion, as stated, appears to recognize that Phillips' 1959-1960 revenues *exceed* cost of service.

Hence, assumed general cost increases cannot justify delaying indefinitely the test of Phillips' high initial prices under Section 5(a) of the Act. As the Supreme Court emphasized in CATCO (360 U.S. at 389-390):

> . . . the delay incident to determination in § 5 proceedings through which initial certificated rates are reviewable appears nigh interminable. Although *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672, 98 L.ed. 1035, 74 S.Ct. 794, was decided in 1954, cases instituted under § 5 are still in the investigative stage. This long delay, without the protection of refund, as is possible in a § 4 proceeding, would provide a windfall for the natural gas company with a consequent squall for the consumers. *This the Congress did not intend.* [Emphasis supplied]

IV.

The Commission Should Direct Phillips To Submit Revised Rate Schedules Which Will Recover Its 1959 Costs, Determined In Accordance With Opinion 338.

The data assembled in the appendices to this petition, while admittedly and unavoidably incomplete, demonstrate that the Commission will abuse its discretion if it terminates this proceeding without fixing Phillips' just and reasonable rates, so as to give Phillips' customers in *this* proceeding the protection contemplated by Sections 4(e) and 5(a) of the Natural Gas Act. The Commission should grant rehearing, consolidate herein all of Phillips' Section 4(e) proceedings and direct Phillips to submit a 1959 cost of service determination based on the practices and methods set forth in Opinion No. 338, as well as revised rates schedules designed to return its current costs. Consideration of these rate schedules and cost of service in a single hearing should take substantially less time than hearings on the unconsolidated Section 4(e)'s. In preparing new rate schedules, Phillips would of course have available for guidance the Commission's Policy Statement 61-1. This procedure

would best serve the purpose of the Commission's proposal for settlement of Phillips' outstanding Section 4(e) proceedings (mimeo, p. 53).

The Eastern Seaboard Companies would welcome, and will make every effort to expedite, complete disposition or settlement of all of Phillips' pending rate controversies, so that this long continued proceeding can be concluded as rapidly as possible.

Respectfully submitted,

LONG ISLAND LIGHTING COMPANY
PHILADELPHIA ELECTRIC COMPANY
THE UNITED GAS IMPROVEMENT COMPANY

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October 28, 1960.

32832

DISTRICT OF COLUMBIA)
CITY OF WASHINGTON) ss.

J. David Mann, Jr., being duly sworn according to law, deposes and says that he is Attorney for the Eastern Seaboard Companies, Applicants herein; that he is authorized to make this affidavit; that he has read the foregoing Application for Rehearing; that he is familiar with the facts set forth therein, and that such facts are true and correct to the best of his knowledge and belief.

J. DAVID MANN, JR.

Subscribed and sworn to before me this 28th day of October, 1960.

SHELVA JEAN FRENZEL
Notary Public

My Commission Expires:
January 31, 1965

[SEAL]

COMPARISON OF ANNUAL REVENUES BASED ON 1954 VOLUMES FOR PHILLIPS' MAJOR SALES UNDER 1954 RATES AND RATES ON FILE AS OF SEPTEMBER 28, 1960, EXCLUDING REVENUES FROM NEW SALES, CASINGHEAD AND "DE MINIMIS" CONTRACTS*

Rate Schedule Number	Purchaser	County	State	Area Designation	F.P.C. Area Price New Gas	F.P.C. Area Price Old Gas	1954 Volume (Mcf)	1954 Price per Mcf	Revenue at 1954 Price
					(14.65 Psia)		(14.65 Psia)		
2-A	Texas Eastern Trans. Corp.	Orange	T	R. R. #3	18.0¢	14.0¢	2,477,038	12.8116¢	$ 317,348.97
3	Tennessee Gas Trans. Co.	Hidalgo	T	R. R. #4	18.0	14.0	165,333	9.8172	16,231.02
4	Michigan-Wisconsin PL Co.	Sherman, Hansford Texas	T O	R. R. #10 Panhandle	17.0	11.0	126,671,655	8.7492[1]	11,082,716.85
5	Panhandle Eastern PL Co.								
	Hansford Plant	Hansford, Moore	T	R. R. #10	17.0	11.0	12,476,091	4.5968	573,494.77
	Hansford Plant	Texas	O	Panhandle	17.0	11.0	19,837,564	9.8301	1,950,054.91
	Sneed Plant	Moore	T	R. R. #10	17.0	11.0	20,218,051	4.9800	1,006,856.47
7	El Paso Natural Gas Co.	Ector	T	R. R. #8	16.0	11.0	122,560	7.0012	8,580.68
8	El Paso Natural Gas Co.	Crane	T	R. R. #8	16.0	11.0	341,932	7.0411	24,075.77
9	El Paso Natural Gas Co.	Crane	T	R. R. #8	16.0	11.0	7,013,313	5.8187	408,086.37
10	El Paso Natural Gas Co.	Winkler	T	R. R. #8	16.0	11.0	2,054,887	9.0004	184,948.82
13	United Gas Pipe Line Co.	Panola	T	R. R. #6	15.0	14.0	3,047,243	8.5221	259,689.09
18	Permian Basin Pipe Line Co.	Midland, Upton, Pecos	T	R.R.#8,7-c	16.0	11.0	32,715,906	9.4347[1]	3,086,660.40
19	Consolidated Gas Utilities	Gray	T	R. R. #10	17.0	11.0	12,155,597	11.1118	1,350,707.03
20	Tennessee Gas Trans. Co.	Nueces	T	R. R. #4	18.0	14.0	275,340	9.4435	26,001.69
21	Colo. Interstate Gas Co.	Hutchinson	T	R. R. #10	17.0	11.0	14,565,740	15.0000	2,184,861.00
23	Texas Gas Trans. Corp.	Panola	T	R. R. #6	15.0	14.0	809,060	9.6220	77,847.51
24	Northern Natural Gas Co.	Moore	T	R. R. #10	17.0	11.0	18,541,588	10.8693	2,015,332.02
27	Texas Ill. Nat. Gas PL Co.	Brazoria	T	R. R. #3	18.0	14.0	10,220,000	9.5506	976,069.89
31	Arkansas Louisiana Gas Co.	Harrison	T	R. R. #6	15.0	14.0			
		Caddo	L	No. La.	16.6[2]	13.7[2]	714,458	9.1439	65,329.10
32	El Paso Natural Gas Co.								
	Goldsmith Plant	Ector	T	R. R. #8	16.0	11.0	25,600,659	7.0002	1,792,563.17
	Eunice Plant	Lea	NM	P.B.	16.0	11.0	12,433,435	7.0000	870,340.45
	Fullerton Plant	Andrews	T	R. R. #8	16.0	11.0	5,889,576	7.0015	412,356.08
	Dumas Plant	Carson	T	R. R. #10	17.0	11.0	38,780,996	9.3294	3,618,027.37
33	El Paso Natural Gas Co.	Ector	T	R. R. #8	16.0	11.0	8,577,295	7.0021	600,591.75
39	Tennessee Gas Trans. Co.	Matagorda	T	R. R. #3	18.0	14.0	167,488	9.2349	15,467.36
41	Tex.-Ill. Nat. Gas PL Co.	Brazoria	T	R. R. #3	18.0	14.0	6,503,518	15.1339	984,237.57
42	Texas Gas Corp.	Jefferson	T	R. R. #3	18.0	14.0	150,976	7.9218	11,959.95
47	El Paso Natural Gas Co.	Upton	T	R.R. #7-c	16.0	11.0	1,292	9.9605	128.69
48	Arkansas Louisiana Gas Co.	Bossier, Webster	L	No. La.	16.6[2]	13.7[2]	20,839	9.6247	2,005.70
52[4]	Panhandle Eastern PL Co.	Moore	T	R. R. #10	17.0	11.0	321,406	1.3568	4,360.86
59	Permian Basin Pipe Line Co.	Lea	NM	P.B.	16.0	11.0	408,304	9.8425	40,187.33
51[4]	Panhandle Eastern PL Co.	Moore	T	R. R. #10	17.0	11.0	7,598,048	2.8742	218,380.44
64	El Paso Natural Gas Co.	Lea	NM	P.B.	16.0	11.0	13,476,859	7.0000	943,380.13
65	El Paso Natural Gas Co.	Lea	NM	P.B.	16.0	11.0	505,830	9.5635	48,374.92

COMPARISON OF ANNUAL REVENUES BASED ON 1954 VOLUMES FOR PHILLIPS' MAJOR SALES UNDER 1954 RATES AND RATES ON FILE AS OF SEPTEMBER 28, 1960, EXCLUDING REVENUES FROM NEW SALES, CASINGHEAD AND "DE MINIMIS" CONTRACTS*

County	State	Area Designation	F.P.C. Area Price New Gas (14.65 Psia)	F.P.C. Area Price Old Gas (14.65 Psia)	1954 Volume (Mcf) (14.65 Psia)	1954 Price per Mcf	Revenue at 1954 Price	Filed Rate as of 9/28/60 (14.65 Psia)	Revenue at 1960 Filed Rate	Increase in Revenue 1954-1960
Orange	T	R. R. #3	18.0¢	14.0¢	2,477,038	12.8116¢	$ 317,348.97	14.8000¢	$ 366,601.62	$ 49,252.65
Hidalgo	T	R. R. #4	18.0	14.0	165,333	9.8172	16,231.02	17.2435	28,509.20	12,278.18
Sherman,Hansford Texas	T O	R. R. #10 Panhandle	17.0	11.0	126,671,655	8.7492[1]	11,082,716.85	12.7295[2]	16,124,668.32	5,041,951.47
Hansford,Moore	T	R. R. #10	17.0	11.0	12,476,091	4.5968	573,494.77	13.0000	1,621,891.83	1,048,397.06
Texas	O	Panhandle	17.0	11.0	19,837,564	9.8301	1,950,054.91	13.0000	2,578,883.32	628,828.41
Moore	T	R. R. #10	17.0	11.0	20,218,051	4.9800	1,006,856.47	13.0000	2,628,346.63	1,621,490.16
Ector	T	R. R. #8	16.0	11.0	122,560	7.0012	8,580.68	17.1286	20,992.81	12,412.13
Crane	T	R. R. #8	16.0	11.0	341,932	7.0411	24,075.77	13.3632[3]	45,693.06	21,617.29
Crane	T	R. R. #8	16.0	11.0	7,013,313	5.8187	408,086.37	13.3632	937,203.04	529,116.67
Winkler	T	R. R. #8	16.0	11.0	2,054,887	9.0004	184,948.82	17.1286	351,973.37	167,024.55
Panola	T	R. R. #6	15.0	14.0	3,047,243	8.5221	259,689.09	9.5000	289,488.08	29,798.99
Midland, Upton, Pecos	T	R.R.#8,7-c	16.0	11.0	32,715,906	9.4347[1]	3,086,660.40	11.1056	3,633,297.66	546,637.26
Gray	T	R. R. #10	17.0	11.0	12,155,597	11.1118	1,350,707.03	14.1792	1,723,566.41	372,859.38
Nueces	T	R. R. #4	18.0	14.0	275,340	9.4435	26,001.69	17.0242	46,874.43	20,872.74
Hutchinson	T	R. R. #10	17.0	11.0	14,565,740	15.0000	2,184,861.00	17.1632	2,499,947.09	315,086.09
Panola	T	R. R. #6	15.0	14.0	809,060	9.6220	77,847.51	10.5000	84,951.30	7,103.79
Moore	T	R. R. #10	17.0	11.0	18,541,588	10.8693	2,015,332.02	14.4443	2,678,202.60	662,870.58
Brazoria	T	R. R. #3	18.0	14.0	10,220,000	9.5506	976,069.89	10.8951	1,113,479.22	137,409.33
Harrison Caddo	T L	R. R. #6 No. La.	15.0 16.6[2]	14.0 13.7[2]	714,458	9.1439	65,329.10	11.5055	82,201.97	16,872.87
Ector	T	R. R. #8	16.0	11.0	25,600,659	7.0002	1,792,563.17	13.6155	3,485,657.73	1,693,094.56
Lea	NM	P.B.	16.0	11.0	12,433,435	7.0000	870,340.45	13.5330	1,682,616.76	812,276.31
Andrews	T	R. R. #8	16.0	11.0	5,889,576	7.0015	412,356.08	13.6155	801,895.22	389,539.14
Carson	T	R. R. #10	17.0	11.0	38,780,996	9.3294	3,618,027.37	19.7633	7,664,404.58	4,046,377.21
Ector	T	R. R. #8	16.0	11.0	8,577,295	7.0021	600,591.75	13.6155	1,167,841.60	567,249.85
Matagorda	T	R. R. #3	18.0	14.0	167,488	9.2349	15,467.36	16.1695	27,081.97	11,614.61
Brazoria	T	R. R. #3	18.0	14.0	6,503,518	15.1339	984,237.57	15.6000	1,014,548.81	30,311.24
Jefferson	T	R. R. #3	18.0	14.0	150,976	7.9218	11,959.95	11.0000[2]	16,607.36	4,647.41
Upton	T	R.R. #7-c	16.0	11.0	1,292	9.9605	128.69	15.7092	202.96	74.27
Bossier,Webster	L	No. La.	16.6[2]	13.7[2]	20,839	9.6247	2,005.70	12.2407	2,550.84	545.14
Moore	T	R. R. #10	17.0	11.0	321,406	1.3568	4,360.86	10.0000	32,140.60	27,779.74
Lea	NM	P.B.	16.0	11.0	408,304	9.8425	40,187.33	10.5000	42,871.92	2,684.59
Moore	T	R. R. #10	17.0	11.0	7,598,048	2.8742	218,380.44	10.0000	759,804.80	541,424.36
Lea	NM	P.B.	16.0	11.0	13,476,859	7.0000	943,380.13	13.5330	1,823,823.33	880,443.20
Lea	NM	P.B.	16.0	11.0	505,830	9.5635	48,374.92	15.5598	78,706.14	30,331.22

Rate Schedule Number	Purchaser	County	State	Area Designation	F.P.C. Ar New Gas
					(14.65
66	El Paso Natural Gas Co.	Lea	NM	P.B.	16.0¢
68	Cities Service Gas Co.	Oklahoma	O	Other	15.0
69	Cities Service Gas Co.	Oklahoma	O	Other	15.0
83	Shamrock Oil & Gas Corp.	Moore	T	R. R. #10	17.0
140	Arkansas Louisiana Gas Co.	Cass	T	R. R. #5	15.0
143[4]	Panhandle Eastern PL Co.	Moore	T	R. R. #10	17.0
148	C. V. Lyman	Winkler	T	R. R. #8	16.0
150	Consolidated Gas Utilities	Grady	O	Carter Knox	16.8
175	Southern Natural Gas Co.	DeSoto	L	No. La.	16.6[2]
202	Texas Northern Gas Corp.	Acadia	L	So. La.	20.96[2]
209	Tennessee Gas Trans. Co.	Colorado,Wharton	T	R. R. #3	18.0
218	Tennessee Gas Trans. Co.	Acadia	L	So. La.	20.96[2]
219	Southern Natural Gas Co.	Plaquemines, St. Bernard	L	So. La.	20.96[2]
220	Transcontinental Gas PL Co.	Vermilion	L	So. La.	20.96[2]
231	Tennessee Gas Trans. Co.	Wharton	T	R. R. #3	18.0
239	Mississippi River Fuel Corp.	Lincoln	L	No. La.	16.6[2]
243	El Paso Natural Gas Co.				
	Lee Plant	Lea	NM	P.B.	16.0
	Hobbs Plant	Lea	NM	P.B.	16.0
262[5]	Northern Natural Gas Co.	Gray	T	R. R. #10	17.0
270[4]	Panhandle Eastern PL Co.	Moore	T	R. R. #10	17.0
J.E. 1[7]	Cities Service Gas Co.	Oklahoma	O	Other	15.0
J.E. 2[7]	Cities Service Gas Co.	Oklahoma	O	Other	15.0
		Total			

State Code:
T - Texas
O - Oklahoma
L - Louisiana
NM - New Mexico

1/ Weighted average price.
2/ Excludes tax.
3/ Rate Schedule #8 superseded by #9.
4/ Rate Schedule #356 supersedes #52, #61, #143, #270.
5/ Rate Schedule #262 supersedes #26 and #28.
6/ Price shown on Exhibit 223 is incorrectly shown as 9.9644.
7/ West Edmond Oil Co.

*Contracts which have terminated since 1954 are not included.

1954 Data are from Exhibits 223 and 289 In the Matter of Phillips Petroleum Company, from the rate schedules, supplements and billing statements on file with the Federal Statement of General Policy No. 61-1, Issued September 28, 1960; First Amendment to October 25, 1960.

. Area Price

Old Gas	1954 Volume (Mcf)	1954 Price per Mcf	Revenue at 1954 Price	Filed Rate as of 9/28/60
.65 Psia)	(14.65 Psia)			(14.65 Psia)
11.0¢	251,808	9.98164¢	$ 25,134.42	17.0436
11.0	6,477,720	6.7165[1]	435,074.12	7.5930
11.0	1,282,711	6.7165	86,152.90	7.6302
11.0	226,468	6.5000	14,720.39	8.5000
14.0	255,633	6.5793[6]	16,818.86	7.4566
11.0	381,273	2.4408	9,306.09	10.0000
11.0	180,697	6.0000	10,841.79	7.0000
11.0	185,466	10.0000	18,546.51	13.0000
13.7[2]	1,370,081	11.1605	152,908.18	14.1240
13.7[2]	301,220	8.7724	26,424.33	20.2916
14.0	192,035	15.4111	29,594.70	15.9502
13.7[2]	331,990	7.7544	25,743.81	22.2635
13.7[2]	1,097,355	11.8749	130,309.97	23.0841
13.7[2]	513,047	9.3247	47,839.90	22.9622
14.0	243,943	13.2883	32,415.96	15.9502
13.7[2]	470,339	10.8241	50,909.77	12.9222
11.0	3,342,639	6.6808	223,314.05	14.0343
11.0	5,820,272	5.0479	293,801.88	13.5330
11.0	17,914,056	10.5132[1]	1,883,347.39	18.9300
11.0	864,127	5.4490	47,086.31	10.0000
11.0	148,459	6.7200	9,976.44	7.6302
11.0	410,074	6.7200	27,556.97	7.5930
	447,121,290		$38,775,078.87	

pany, Docket Nos. G-1148, et al.; 1960 filed rates are
leral Power Commission. Federal Power Commission,
to Statement of General Policy No. 61-1, Issued

County	State	Area Designation	F.P.C. Area Price New Gas (14.65 Psia)	F.P.C. Area Price Old Gas	1954 Volume (Mcf) (14.65 Psia)	1954 Price per Mcf	Revenue at 1954 Price	Filed Rate as of 9/28/60 (14.65 Psia)	Revenue at 1960 Filed Rate	Increase in Revenue 1954-1960
Lea	NM	P.B.	16.0¢	11.0¢	251,808	9.9816¢	$ 25,134.42	17.0436	$ 42,917.15	$ 17,782.73
Oklahoma	O	Other	15.0	11.0	6,477,720	6.7165[1]	435,074.12	7.5930	491,853.28	56,779.16
Oklahoma	O	Other	15.0	11.0	1,282,711	6.7165	86,152.90	7.6302	97,873.41	11,720.51
Moore	T	R. R. #10	17.0	11.0	226,468	6.5000	14,720.39	8.5000	19,249.78	4,529.39
Cass	T	R. R. #6	15.0	14.0	255,633	6.5793[6]	16,818.86	7.4566	19,061.53	2,242.67
Moore	T	R. R. #10	17.0	11.0	381,273	2.4408	9,306.09	10.0000	38,127.30	28,821.21
Winkler	T	R. R. #8	16.0	11.0	180,697	6.0000	10,841.79	7.0000	12,648.79	1,807.00
Grady	O	Carter Knox	16.8	11.0	185,466	10.0000	18,546.51	13.0000	24,110.58	5,564.07
DeSoto	L	No. La.	16.6[2]	13.7[2]	1,370,081	11.1605	152,908.18	14.1240	193,510.24	40,602.06
Acadia	L	So. La.	20.96[2]	13.7[2]	301,220	8.7724	26,424.33	20.2916	61,122.36	34,698.03
Colorado,Wharton	T	R. R. #3	18.0	14.0	192,035	15.4111	29,594.70	15.9502	30,629.97	1,035.27
Acadia	L	So. La.	20.96[2]	13.7[2]	331,990	7.7544	25,743.81	22.2635	73,912.59	48,168.78
Plaquemines, St. Bernard	L	So. La.	20.96[2]	13.7[2]	1,097,355	11.8749	130,309.97	23.0841	253,314.53	123,004.56
Vermilion	L	So. La.	20.96[2]	13.7[2]	513,047	9.3247	47,839.90	22.9622	117,806.88	69,966.98
Wharton	T	R. R. #3	18.0	14.0	243,943	13.2883	32,415.96	15.9502	38,909.40	6,493.44
Lincoln	L	No. La.	16.6[2]	13.7[2]	470,339	10.8241	50,909.77	12.9222	60,778.15	9,868.38
Lea	NM	P.B.	16.0	11.0	3,342,639	6.6808	223,314.05	14.0343	469,115.99	245,801.94
Lea	NM	P.B.	16.0	11.0	5,820,272	5.0479	293,801.88	13.5330	787,657.41	493,855.53
Gray	T	R. R. #10	17.0	11.0	17,914,056	10.5132[1]	1,883,347.39	18.9300	3,391,130.80	1,507,783.41
Moore	T	R. R. #10	17.0	11.0	864,127	5.4490	47,086.31	10.0000	86,412.70	39,326.39
Oklahoma	O	Other	15.0	11.0	148,459	6.7200	9,976.44	7.6302	11,327.72	1,351.28
Oklahoma	O	Other	15.0	11.0	410,074	6.7200	27,556.97	7.5930	31,136.92	3,579.95
Total					447,121,290		$38,775,078.87		$61,810,134.06	$23,035,055.19

#9.
52, #61, #143, #270.
26 and #28.
ncorrectly shown as 9.9644.

nce 1954 are not included.

289 In the Matter of Phillips Petroleum Company, Docket Nos. G-1148, et al.; 1960 filed rates are
s and billing statements on file with the Federal Power Commission. Federal Power Commission,
1, Issued September 28, 1960; First Amendment to Statement of General Policy No. 61-1, Issued

Comparison of Prices Under "New" Rate Schedules,* Not Included in Docket No. G-1148 et al., With Area Rate Standards Set Forth in Statement of General Policy No. 61-1 and First Amendment Thereto

Rate Schedule Number	Purchaser	County	State	Area Designation	F.P.C. AREA PRICE (14.65 Psia) New Gas	F.P.C. AREA PRICE (14.65 Psia) Old Gas	Filed Rate as of 9/28/60
273	United Fuel Gas Company	Vermilion	Louisiana	So. La.	20.96¢ 1/	13.70¢ 1/	22.3099¢
274	El Paso Natural Gas Company	Lea	New Mexico	Permian Basin	16.00	11.00	15.5598
275	Wilcox Trend Gathering System, Inc.	Live Oak	Texas	R.R. #2	18.00	14.00	11.8254
276	Louisiana Nevada Transit Company	Webster	Louisiana	No. La.	16.60 1/	13.70 1/	11.7005
277	Colorado Interstate Gas Company	Haskell	Kansas	Kansas	16.00	11.00	12.0900
278	American Louisiana Pipe Line Company	Acadia, St. Landry	Louisiana	So. La.	20.96 1/	13.70 1/	20.9634
279	Pacific Northwest Pipe Line Corp.	Sublette	Wyoming	Wyoming	15.00	12.70	19.0133
281	Texas Eastern Transmission Corp.	Live Oak	Texas	R.R. #2	18.00	14.00	11.8254
282	Warren Petroleum Corp.	Wheeler	Texas	R.R. #10	17.00	11.00	5.2500
286	Texas Eastern Transmission Corp.	Gregg	Texas	R.R. #6	15.00	14.00	14.8000
288	Kerr-McGee Oil Industries, Inc.	Carson	Texas	R.R. #10	17.00	11.00	11.3057
289	Kansas-Nebraska Natural Gas Co., Inc.	Texas	Oklahoma	Panhandle	17.00	11.00	16.0000 1/
290	Panhandle Eastern Pipeline Co.	Texas	Oklahoma	Panhandle	17.00	11.00	16.0000
291	Pioneer Gathering System, Inc.	Val Verde	Texas	R.R. #1	15.00	14.00	10.7500
292	Natural Gas Pipeline Co. of America	Beaver	Oklahoma	Panhandle	17.00	11.00	16.6000
294	Northern Natural Gas Company	Hansford	Texas	R.R. #10	17.00	11.00	16.5000
295	United Gas Pipe Line Company	Terrebonne	Louisiana	So. La.	20.96 1/	13.70 1/	19.5008 1/
296	Panhandle Eastern Pipeline Company	Meade	Kansas	Kansas	16.00	11.00	15.0000
297	Cities Service Gas Company	Woods	Oklahoma	Other	15.00	11.00	12.0000
298	Natural Gas Pipeline Co. of America	Texas	Oklahoma	Panhandle	17.00	11.00	16.8000
299	Southern Natural Gas Company	Plaquemines	Louisiana	So. La.	20.96 1/	13.70 1/	23.0841
300	Southern Natural Gas Company	Plaquemines	Louisiana	So. La.	20.96 1/	13.70 1/	23.0841
301	Southern Natural Gas Company	Plaquemines	Louisiana	So. La.	20.96 1/	13.70 1/	23.0841
302	Kansas-Nebraska Natural Gas Co., Inc.	Texas	Oklahoma	Panhandle	17.00	11.00	16.6000
303	Pacific Northwest Pipeline Corp.	Rio Blanco	Colorado	Colorado	14.60	12.70	14.6256
304	Arkansas Louisiana Gas Company	Claiborne	Louisiana	No. La.	16.60 1/	13.70 1/	12.2407
306	Permian Basin Pipeline Company	Winkler	Texas	R.R. #8	16.00	11.00	16.0000
307	Natural Gas Pipeline Co. of America	Texas	Oklahoma	Panhandle	17.00	11.00	16.6000
309 2/	El Paso Natural Gas Co.; Hunt Oil Co.	Upton	Texas	R.R. #7-C	16.00	11.00	13.6822
310 2/	Montana-Dakota Utilities Company	Park	Wyoming	Wyoming	15.00	12.70	7.8003
311	Consolidated Gas Utilities Corp.	Grady	Oklahoma	Other	15.00	11.00	11.0000
312	Texas Gas Gathering Corp.	Tensas	Louisiana	No. La.	16.60 1/	13.70 1/	14.1381
313	Panhandle Eastern Pipeline Company	Seward	Kansas	Kansas	16.00	11.00	15.0000
314	Panhandle Eastern Pipeline Company	Hansford	Texas	R.R. #10	17.00	11.00	16.0000
315	El Paso Natural Gas Company	Reagan	Texas	R.R. #7-C	16.00	11.00	17.2295
317	Trunkline Gas Company	Brazoria	Texas	R.R. #3	18.00	14.00	20.0000
318	Trunkline Gas Company	Galveston	Texas	R.R. #3	18.00	14.00	20.0000
319	United Gas Pipe Line Company	Panola	Texas	R.R. #6	15.00	14.00	13.0000
321	Cities Service Gas Company	Barber	Kansas	Kansas	16.00	11.00	13.0000
322	United Gas Pipe Line Company	San Patricio, Nueces	Texas	R.R. #4	18.00	14.00	14.8000
323	Lone Star Gas Company	Carter	Oklahoma	Other	15.00	11.00	13.2000 3/

Comparison of Prices Under "New" Rate Schedules,* Not Included in Docket No. G-1148 et al., With Area Rate Standards Set Forth in Statement of General Policy No. 61-1 and First Amendment Thereto

Purchaser	County	State	Area Designation	F.P.C. AREA PRICE (14.65 Psia) New Gas	F.P.C. AREA PRICE (14.65 Psia) Old Gas	Filed Rate as of 9/28/60	Latest Indicated Annual Volume	Annual Revenue at 1960 Filed Rate	Docket Numbers § 4e Proceedings	Docket Numbers Certific Proceedin
United Fuel Gas Company	Vermilion	Louisiana	So. La.	20.96¢/	13.70¢/	22.3099¢	23,890,032	$5,329,842	G-20013	
El Paso Natural Gas Company	Lea	New Mexico	Permian Basin	16.00	11.00	15.5598	401,543	62,479	G-20403	
Wilcox Trend Gathering System, Inc.	Live Oak	Texas	R.R. #2	18.00	14.00	11.8254	32,546	3,849		
Louisiana Nevada Transit Company	Webster	Louisiana	No. La.	16.60¢/	13.70¢/	11.7005	713,816	83,520		
Colorado Interstate Gas Company	Haskell	Kansas	Kansas	16.00	11.00	12.0900	120,816	14,607		
American Louisiana Pipe Line Company	Acadia, St. Landry	Louisiana	So. La.	20.96¢/	13.70¢/	20.9634	1,282,827	268,924	G-15597	
Pacific Northwest Pipe Line Corp.	Sublette	Wyoming	Wyoming	15.00	12.70	19.0133	1,015,536	193,087	G-16713	
Texas Eastern Transmission Corp.	Live Oak	Texas	R.R. #2	18.00	14.00	11.8254	29,200	3,453		
Warren Petroleum Corp.	Wheeler	Texas	R.R. #10	17.00	11.00	5.2500	72,000	3,780		
Texas Eastern Transmission Corp.	Gregg	Texas	R.R. #6	15.00	14.00	14.8000	15,344	2,271	G-19581	
Kerr-McGee Oil Industries, Inc.	Carson	Texas	R.R. #10	17.00	11.00	11.3057	5,920	669	RI60-475	
Kansas-Nebraska Natural Gas Co., Inc.	Texas	Oklahoma	Panhandle	17.00	11.00	16.0000[1]	260,400	41,664		
Panhandle Eastern Pipeline Co.	Texas	Oklahoma	Panhandle	17.00	11.00	16.0000	69,876	11,180		
Pioneer Gathering System, Inc.	Val Verde	Texas	R.R. #1	15.00	14.00	10.7500	4,464,000	479,880		
Natural Gas Pipeline Co. of America	Beaver	Oklahoma	Panhandle	17.00	11.00	16.6000	29,964	4,974	G-18272	
Northern Natural Gas Company	Hansford	Texas	R.R. #10	17.00	11.00	16.5000	1,860,000	306,900		
United Gas Pipe Line Company	Terrebonne	Louisiana	So. La.	20.96¢/	13.70¢/	19.5008[1]	638,562	124,525	G-15752	
Panhandle Eastern Pipeline Company	Meade	Kansas	Kansas	16.00	11.00	15.0000	1,080,000	162,000		
Cities Service Gas Company	Woods	Oklahoma	Other	15.00	11.00	12.0000	99,996	12,000		
Natural Gas Pipeline Co. of America	Texas	Oklahoma	Panhandle	17.00	11.00	16.8000	125,504	21.085	G-20339	
Southern Natural Gas Company	Plaquemines	Louisiana	So. La.	20.96¢/	13.70¢/	23.0841	2,335,525	539,135	G-17156	
Southern Natural Gas Company	Plaquemines	Louisiana	So. La.	20.96¢/	13.70¢/	23.0841	2,758,942	636,877	G-17156	
Southern Natural Gas Company	Plaquemines	Louisiana	So. La.	20.96¢/	13.70¢/	23.0841	1,738,780	401,382	G-17267	
Kansas-Nebraska Natural Gas Co., Inc.	Texas	Oklahoma	Panhandle	17.00	11.00	16.6000	7,299	1,212	RI61-64	
Pacific Northwest Pipeline Corp.	Rio Blanco	Colorado	Colorado	14.60	12.70	14.6256	572,283	83,700		
Arkansas Louisiana Gas Company	Claiborne	Louisiana	No. La.	16.60¢/	13.70¢/	12.2407	70,346	8,611	G-15721	
Permian Basin Pipeline Company	Winkler	Texas	R.R. #8	16.00	11.00	16.0000	310,000	49,600		
Natural Gas Pipeline Co. of America	Texas	Oklahoma	Panhandle	17.00	11.00	16.6000	30,990	5,144	G-18272	
El Paso Natural Gas Co.; Hunt Oil Co.	Upton	Texas	R.R. #7-C	16.00	11.00	13.6822	64,718	8,855	G-20523	
Montana-Dakota Utilities Company	Park	Wyoming	Wyoming	15.00	12.70	7.8003	26,619	2,076		
Consolidated Gas Utilities Corp.	Grady	Oklahoma	Other	15.00	11.00	11.0000	Indeterminable	--		
Texas Gas Gathering Corp.	Texas	Louisiana	No. La.	16.60¢/	13.70¢/	14.1381	457,827	64,728		
Panhandle Eastern Pipeline Company	Seward	Kansas	Kansas	16.00	11.00	15.0000	960,000	144,000		
Panhandle Eastern Pipeline Company	Hansford	Texas	R.R. #10	17.00	11.00	16.0000	72,000	11,520		
El Paso Natural Gas Company	Reagan	Texas	R.R. #7-C	16.00	11.00	17.2295	177,401	30,565	G-20405	
Trunkline Gas Company	Brazoria	Texas	R.R. #3	18.00	14.00	20.0000	9,300,000	1,860,000		
Trunkline Gas Company	Galveston	Texas	R.R. #3	18.00	14.00	20.0000	5,580,000	1,116,000		
United Gas Pipe Line Company	Panola	Texas	R.R. #6	15.00	14.00	13.0000	495,876	64,464		
Cities Service Gas Company	Barber	Kansas	Kansas	16.00	11.00	13.0000	106,884	13,895	G-20339	
United Gas Pipe Line Company	San Patricio, Nueces	Texas	R.R. #4	18.00	14.00	14.8000	246,600	36,497		
Lone Star Gas Company	Carter	Oklahoma	Other	15.00	11.00	13.3000[3]	30,000	3,990	RI60-201	

Comparison of Prices Under "New" Rate Schedules,* Not Included in Docket No. G-1148 et al., With Area Rate Standards Set Forth in Statement of General Policy No. 61-1 and First Amendment Thereto

Rate Schedule Number	Purchaser	County	State	Area Designation	F.P.C. AREA PRICE (14.65 Psia) New Gas	F.P.C. AREA PRICE (14.65 Psia) Old Gas	Filed Rate as of 9/28/60	Latest Indicated Annual Volume
324	Lone Star Gas Company	Carter	Oklahoma	Other	15.00¢	11.00¢	16.8000 4/¢	43,000
325	Cities Service Gas Company	Garvin	Oklahoma	Other	15.00	11.00	11.0000	4,320,000
326	Natural Gas Pipeline Co. of America	Jack	Texas	R.R. #9	14.00	14.00	13.0000	1,488,000
327	Panhandle Eastern Pipeline Company	Reno	Kansas	Kansas	16.00	11.00	13.0000	337,500
328	United Gas Pipe Line Company	Refugio	Texas	R.R. #2	18.00	14.00	12.1536	306,720
329	Commonwealth Oil Company	Vermilion	Louisiana	So. La.	20.96 1/	13.70 1/	19.9234 5/	22,891,325
330	Tennessee Gas Transmission Company	Cameron	Louisiana	So. La.	20.96 1/	13.70 1/	22.2634	4,451,486
331	West Texas Gathering Company	Winkler	Texas	R.R. #8	16.00	11.00	16.0000	540,000
332	Natural Gas Pipeline Co. of America	Beaver	Oklahoma	Panhandle	17.00	11.00	16.8000	231,223
333	Not Available							
336	Northern Natural Gas Company	Beaver	Oklahoma	Panhandle	17.00	11.00	15.0000	43,200
338	El Paso Natural Gas Company	Lea	New Mexico	Permian Basin	16.00	11.00	17.0657	185,401
339	Coastal States Gas Producing Company	Bee	Texas	R.R. #2	18.00	14.00	10.0000	396,012
340	Not Available							
341	Cities Service Gas Company	Harper	Oklahoma	Panhandle	17.00	11.00	12.0000	651.000
342	Transcontinental Gas P. L. Corp.	Terrebonne	Louisiana	So. La.	20.96 1/	13.70 1/	23.4498	763,044
343	Wunderlick Development Company	Kay	Oklahoma	Other	15.00	11.00	6.2000	21,600
344	Lone Star Gas Company	Grady, Stephens	Oklahoma	Carter Knox	16.80	11.00	16.8000	12,000
345	New York State Natural Gas Corp.	Potter	Pennsylvania	Pennsylvania			26.2887	381,357
346	Kerr-McGee Oil Industries, Inc., & Rock-Pam Gas Gathering	Gray	Texas	R.R. #10	17.00	11.00	12.0000	2,976,000
347	Texas Gas Transmission Corp.	Webster	Louisiana	No. La.	16.60 1/	13.70 1/	13.4068	53,413
348	Texas Gas Transmission Corp.	Webster, Claiborne	Louisiana	No. La.	16.60 1/	13.70 1/	17.7945	371,984
349	Texas Gas Transmission Corp.	Webster	Louisiana	No. La.	16.60 1/	13.70 1/	15.3569	272,050
350	Transcontinental Gas P. L. Corp.	St. Mary	Louisiana	So. La.	20.96 1/	13.70 1/	21.4509	
		Cameron	Louisiana	So. La.	20.96 1/	13.70 1/	23.2060	11,445,663
351	Michigan Wisconsin Pipe Line Co.	Harper, Beaver	Oklahoma	Panhandle	17.00	11.00	17.0000	360,000
352	Coastal Transmission Corp.	Nueces	Texas	R.R. #4	18.00	14.00	16.5000	945,000
353	Panhandle Eastern Pipeline Company	Texas	Oklahoma	Panhandle				
		Hansford	Texas	R.R. #10	17.00	11.00	16.0000	360,000
354	Southern Natural Gas Company	St. Martin	Louisiana	So. La.	20.96 1/	13.70 1/	22.6697	738,430
355 7/	Hope Natural Gas Company	Cameron	Louisiana	So. La.	20.96 1/	13.70 1/	22.9622	1,927,302
356 7/	Panhandle Eastern Pipeline Company	Moore	Texas	R.R. #10	17.00	11.00	10.0000	6,208,838
357	Not Available							
358	El Paso Natural Gas Company	Crockett	Texas	R.R. #7-C	16.00	11.00	14.6958	63,366
359	El Paso Natural Gas Company	Winkler	Texas	R.R. #8	16.00	11.00	17.1632	2,555,000
360	United Gas Pipe Line Company	Jackson	Texas	R.R. #2	18.00	14.00	14.0018	518,172
361	Northern Natural Gas Company	Harper	Oklahoma	Panhandle	17.00	11.00	15.0000	15,324
362	Colorado Interstate Gas Company	Beaver	Oklahoma	Panhandle	17.00	11.00	15.0000	180,000

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Purchaser	County	State	Area Designation	F.P.C. AREA PRICE (14.65 Psia) New Gas	F.P.C. AREA PRICE (14.65 Psia) Old Gas	Filed Rate as of 9/28/60	Latest Indicated Annual Volume	Annual Revenue at 1960 Filed Rate	Docket Numbers $ 4e Proceedings	Docket Numbers Certificate Proceedings**
Lone Star Gas Company	Carter	Oklahoma	Other	15.00¢	11.00¢	16.8000[4]¢	43,000	$ 7,224	RI60-201	
Cities Service Gas Company	Garvin	Oklahoma	Other	15.00	11.00	11.0000	4,320,000	475,200		
Natural Gas Pipeline Co. of America	Jack	Texas	R.R. #9	14.00	14.00	13.0000	1,488,000	193,440		
Panhandle Eastern Pipeline Company	Reno	Kansas	Kansas	16.00	11.00	13.0000	337,500	43,875		
United Gas Pipe Line Company	Refugio	Texas	R.R. #2	18.00	14.00	12.1536	306,720	37,278		
Commonwealth Oil Company	Vermilion	Louisiana	So. La.	20.96[1]/	13.70[1]/	19.9234[5]/	22,891,325	4,560,730		Pending
Tennessee Gas Transmission Company	Cameron	Louisiana	So. La.	20.96[1]/	13.70[1]/	22.2634	4,451,486	991,052		Pending
West Texas Gathering Company	Winkler	Texas	R.R. #8	16.00	11.00	16.0000	540,000	86,400		Withdrawn
Natural Gas Pipeline Co. of America	Beaver	Oklahoma	Panhandle	17.00	11.00	16.8000	231,223	38,845	RI60-169	
Not Available										
Northern Natural Gas Company	Beaver	Oklahoma	Panhandle	17.00	11.00	15.0000	43,200	6,480		
El Paso Natural Gas Company	Lea	New Mexico	Permian Basin	16.00	11.00	17.0657	185,401	31,640	G-20405	
Coastal States Gas Producing Company	Bee	Texas	R.R. #2	18.00	14.00	10.0000	396,012	39,601		
Not Available										
Cities Service Gas Company	Harper	Oklahoma	Panhandle	17.00	11.00	12.0000	651.000	78,120		
Transcontinental Gas P. L. Corp.	Terrebonne	Louisiana	So. La.	20.96[1]/	13.70[1]/	23.4498	763,044	178,932		Cert.not yet accepted
Wunderlick Development Company	Kay	Oklahoma	Other	15.00	11.00	6.2000	21,600	1,339		
Lone Star Gas Company	Grady, Stephens	Oklahoma	Carter Knox	16.80	11.00	16.8000	12,000	2,016		
New York State Natural Gas Corp.	Potter	Pennsylvania	Pennsylvania			26.2887	381,357	100,254		
Kerr-McGee Oil Industries, Inc., & Rock-Pam Gas Gathering	Gray	Texas	R.R. #10	17.00	11.00	12.0000	2,976,000	357,120		
Texas Gas Transmission Corp.	Webster	Louisiana	No. La.	16.60[1]/	13.70[1]/	13.4058	53,413	7,161		
Texas Gas Transmission Corp.	Webster, Claiborne	Louisiana	No. La.	16.60[1]/	13.70[1]/	17.7945	371,984	66,193		
Texas Gas Transmission Corp.	Webster	Louisiana	No. La.	16.60[1]/	13.70[1]/	15.3569	272,050	41,778		
Transcontinental Gas P. L. Corp.	St. Mary	Louisiana	So. La.	20.96[1]/	13.70[1]/	21.4509				
	Cameron	Louisiana	So. La.	20.96[1]/	13.70[1]/	23.2060	11,445,663	2,555,588[6]/		
Michigan Wisconsin Pipe Line Co.	Harper, Beaver	Oklahome	Panhandle	17.00	11.00	17.0000	360,000	61,200		Temp. cert.
Coastal Transmission Corp.	Nueces	Texas	R.R. #4	18.00	14.00	16.5000	945,000	155,925		
Panhandle Eastern Pipeline Company	Texas	Oklahoma	Panhandle							
	Hansford	Texas	R.R. #10	17.00	11.00	16.0000	360,000	57,600		
Southern Natural Gas Company	St. Martin	Louisiana	So. La.	20.96[1]/	13.70[1]/	22.6697	738,430	167,400		
Hope Natural Gas Company	Cameron	Louisiana	So. La.	20.96[1]/	13.70[1]/	22.9622	1,927,302	442,551		
Panhandle Eastern Pipeline Company	Moore	Texas	R.R. #10	17.00	11.00	10.0000	6,208,838	620,884		
Not Available										
El Paso Natural Gas Company	Crockett	Texas	R.R. #7-C	16.00	11.00	14.6958	63,366	9,312	RI60-2	
El Paso Natural Gas Company	Winkler	Texas	R.R. #8	16.00	11.00	17.1632	2,555,000	438,520	RI61-30	
United Gas Pipe Line Company	Jackson	Texas	R.R. #2	18.00	14.00	14.0018	518,172	72,553		Temp. cert.
Northern Natural Gas Company	Harper	Oklahoma	Panhandle	17.00	11.00	15.0000	15,324	2,299		Pending
Colorado Interstate Gas Company	Beaver	Oklahoma	Panhandle	17.00	11.00	15.0000	180,000	27,000		Temp. cert.

Comparison of Prices Under "New" Rate Schedules,* Not Included in Docket No. G-1148 et al., With Area Rate Standards Set Forth in Statement of General Policy No. 61-1 and First Amendment Thereto

Rate Schedule Number	Purchaser	County	State	Area Designation	F.P.C. AREA PRICE (14.65 Psia) New Gas	F.P.C. AREA PRICE (14.65 Psia) Old Gas	Filed Rate as of 9/28/60	Indicated Annual Volume	Annual Revenue at 1960 Filed Rate
363	El Paso Natural Gas Company	Reeves	Texas	R.R. #8	16.00¢	11.00¢	14.6958¢	2,358,509	346,602
364	Transwestern Pipe Line Company	Roberts	Texas	R.R. #10	17.00	11.00	17.0000 8/	744,000	126,480
365	Cities Service Gas Company	Woodward	Oklahoma	Panhandle	17.00	11.00	15.0000	540,000	81,000
366	Cities Service Gas Company	Woodward	Oklahoma	Panhandle	17.00	11.00	15.0000	2,256	338
367	Northern Natural Gas Company	Beaver	Oklahoma	Panhandle	17.00	11.00	15.0000	72,000	10.800
368	Transwestern Pipe Line Company	Pecos	Texas	R.R. #8	16.00	11.00	16.0000	372,000	59,520
369	Not Available								
370 9/	Texas Eastern Transmission Corp.	Lincoln	Louisiana	No. La.	16.60 1/	13.70 1/	15.4063	126,000	19,412
371 9/	Henderson Trust	Hutchinson	Texas	R.R. #5	14.00	14.00	11.0000	73,781	8,116
							Total	131,891,928	$24,820,718

* The last rate schedule included in Phillips' Exhibit 223 was #270; this tabulation includes Rate Schedules #271 through #371, excluding those which are no longer i head and liquids contracts.

** Permanent certificates have been issued by the Commission authoriz enumerated rate schedules, except as noted.

1/ Excludes tax.

2/ Supersedes Rate Schedule #242.

3/ Excludes compression charge.

4/ Less 3.5¢ for miscellaneous.

5/ Excludes 2.4¢ gathering charge.

6/ Using 22.328¢ as the price.

7/ Supersedes Rate Schedules 52, 61, 143, 270.

8/ Conditioned price.

9/ Supersedes Rate Schedule 60.

Source: Phillips Petroleum Company Rate Schedules, supplements and billing statements on file with the Federal Power Commission. Federal Power Commission, Statement No. 61-1, Issued September 28, 1960; First Amendment to Statement of General Policy No. 61-1, Issued October 25, 1960.

Comparison of Prices Under "New" Rate Schedules,* Not Included in Docket No. G-1148 et al., With Area Rate Standards Set Forth in Statement of General Policy No. 61-1 and First Amendment Thereto

County	State	Area Designation	F.P.C. AREA PRICE (14.65 Psia) New Gas	F.P.C. AREA PRICE (14.65 Psia) Old Gas	Filed Rate as of 9/28/60	Indicated Annual Volume	Annual Revenue at 1960 Filed Rate	Docket Numbers § 4e Proceedings	Docket Numbers Certificate Proceedings**
Reeves	Texas	R.R. #8	16.00¢	11.00¢	14.6958¢	2,358,509	346,602	G-20417	
Roberts	Texas	R.R. #10	17.00	11.00	17.0000	744,000	126,480		Temp. cert.
Woodward	Oklahoma	Panhandle	17.00	11.00	15.0000	540,000	81,000		Temp. cert.
Woodward	Oklahoma	Panhandle	17.00	11.00	15.0000	2,256	338		Temp. cert.
Beaver	Oklahoma	Panhandle	17.00	11.00	15.0000	72,000	10.800		Temp. cert.
Pecos	Texas	R.R. #8	16.00	11.00	16.0000	372,000	59,520		Temp. cert.
Lincoln	Louisiana	No. La.	16.60 1/	13.70 1/	15.4063	126,000	19,412		Temp. cert.
Hutchinson	Texas	R.R. #5	14.00	14.00	11.0000	73,781	8,116		Pending
					Total	131,891,928	$24,820,718		

ps' Exhibit 223 was #270; this tabulation includes Rate Schedules #271 through #371, excluding those which are no longer in effect and casing-

** Permanent certificates have been issued by the Commission authorizing service under the enumerated rate schedules, except as noted.

ules, supplements and billing statements on file with the Federal Power Commission. Federal Power Commission, Statement of General Policy endment to Statement of General Policy No. 61-1, Issued October 25, 1960.

PHILLIPS PETROLEUM CO., SECTION 4-e RATE SUSPENSION PROCEEDINGS NOT CONSOLIDATED WITH DOCKET NO. G 1148 ET AL AND PENDING AS OF SEPTEMBER 28, 1960

Purchaser	Rate Schedule No.	Docket No.	Annual Amount Suspended	Effective Subject to Refund
Arkansas - Louisiana Gas Co.	31	G 16,113	2,359	2/26/59
Cities Service Gas Co.	257-298-321	G 20,339	1,527	-
Colorado Interstate Gas Co.	10-57-66	G 18,215	27,880	9/18/59
Colorado Interstate Gas Co.	21	G 11,622	146,897	6/1/57
Colorado Interstate Gas Co.	21	G 20,561	151,134	-
Colorado Interstate Gas Co.	240	G 17,783	428	7/22/59
Consolidated Gas Utilities Corp.	19	G 12,460	63,275	10/12/59
Consolidated Gas Utilities Corp.	19	G 14,930	93,522	10/12/59
Consolidated Gas Utilities Corp.	19	G 18,273	61,302	10/12/59
Consolidated Gas Utilities Corp.	150	G 14,686	2,752	8/27/58
Consolidated Gas Utilities Corp.	19	RI 60-394	288,600	
El Paso Nat. Gas Co.	(Oper.) 7-9-32-33-64-243	G 14,115	3,637,284	6/1/58
El Paso Nat. Gas Co.	(Oper.) 7-9-32-64-243	G 18,417	2,212,624	-
El Paso Nat. Gas Co.	(Oper.) 7-9-64-243	G 20,404	1,090,103	-
El Paso Nat. Gas Co.	10	G 13,734	138,052	5/14/58
El Paso Nat. Gas Co.	10-57-66	G 18,215	27,880	9/18/59
El Paso Nat. Gas Co.	10-47-66-151-260-315-338	G 20,405	137,381	-
El Paso Nat. Gas Co.	(Oper.) et al 32-33-40-65-256-274	G 20,403	3,385,616	-
El Paso Nat. Gas Co.	(Oper.) et al 33	G 18,418	354,443	-
El Paso Nat. Gas Co.	66	G 14,007	3,263	6/1/58
El Paso Nat. Gas Co.	66	G 15,315	1,751	12/1/58
El Paso Nat. Gas Corp.	(Oper.) et al 256	G 14,006	66	6/1/58
El Paso Nat. Gas Corp.	(Oper.) et al 256	G 15,314	145	12/1/58
El Paso Nat. Gas Corp.	(Oper.) et al 256	G 18,206	960	9/13/59

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PHILLIPS PETROLEUM CO., SECTION 4-e RATE SUSPENSION PROCEEDINGS NOT CONSOLIDATED WITH DOCKET NO. G 1148 ET AL AND PENDING AS OF SEPTEMBER 28, 1960

Purchaser	Rate Schedule No.	Docket No.	Annual Amount Suspended	Effective Subject to Refund
El Paso Nat. Gas Co.	309	G 18,207	830	9/13/59
	1	RI60-2	4,101	
	359	RI60-15	150,000	
	359	RI61-30	25,800	
Henderson Trusts	60	RI60-336	7,200	
Hunt Oil Co.	309	G 18,207	830	9/13/59
Kansas-Nebraska Natural Gas Co., Inc.	302	G 16,311	37	3/1/59
Kansas-Nebraska Natural Gas Co., Inc.	302	G 19,474	24	-
Kansas-Nebraska Natural Gas Co., Inc.	247	RI60-93	n/a	
La-Tex Petroleum Products Corp.	(Oper.) et al 218-246	G 16,600	181,125	-
Lone Star Gas Co.	158	G 14,008	-	6/1/58
Lone Star Gas Co.	(Oper.) et al 323	G 16,333	278	3/1/59
Lone Star Gas Co.	324	G 16,339	830	3/1/59
Lone Star Gas Co.	323-24	RI60-201	4,200	
Michigan Wisconsin P/L Co.	4	G 19,032	1,610,504	-
Michigan Wisconsin P/L Co.	4	RI60-349	1,634,600	
Mississippi River Fuel Corp.	22	G 12,283	142	9/3/57
Mississippi River Fuel Corp.	22	RI60-257	350	
Natural Gas P/L Co. of America	257	G 11,723	240	6/24/57
Natural Gas P/L Co. of America	257	G 14,258	177	6/23/58
Natural Gas P/L Co. of America	257-298	G 17,429	478	6/23/59
Natural Gas P/L Co. of America	257-298-321	G 20,339	1,527	-
Natural Gas P/L Co. of America	292-307	G 18,272	122	10/10/59
Natural Gas P/L Co. of America	298	G 14,555	323	7/28/58
Natural Gas P/L Co. of America	307	G 15,013	52	10/10/58
Natural Gas P/L Co. of America	332	G 17,878	499	8/21/59
Natural Gas P/L Co. of America	332	RI60-169	460	

PHILLIPS PETROLEUM CO., SECTION 4-e RATE SUSPENSION PROCEEDINGS NOT CONSOLIDATED WITH DOCKET NO. G 1148 ET AL AND PENDING AS OF SEPTEMBER 28, 1960

Purchaser	Rate Schedule No.	Docket No.	Annual Amount Suspended	Effective Subject to Refund
Northern Natural Gas Co.	24	G 11,641	236,867	6/1/57
Northern Natural Gas Co.	(Oper.) 24	G 17,295	72,528	6/1/59
Northern Natural Gas Co.	176	G 15,088	44	10/24/58
Northern Natural Gas Co.	252	G 14,009	9,132	6/1/58
Northern Natural Gas Co.	262	G 16,178	84,816	3/1/59
Northern Natural Gas Co.	(Oper.) et al 262	G 19,473	89,943	-
Northern Natural Gas Co.	(Oper.) 262	RI60-226	802,600	
Northern Natural Gas Co.	58	RI60-277	980	
Pacific Northwest P/L Corp.	279	G 16,713	34,657	3/25/59
Panhandle Eastern P/L Co.	(Oper.) 5	G 16,112	384,006	9/2/58
Panhandle Eastern P/L Co.	(Oper.) 5	G 19,845	2,717,526	-
Panhandle Eastern P/L Co.	(Oper.) 5	G 20,5[illegible]0	-	-
Permian Basin P/L Co.	18	G 11,849	298,560	7/8/57
Permian Basin P/L Co.	(Oper.) 18	G 17,071	363,567	5/1/59
Southern Natural Gas Co.	219	G 16,083	364,702	-
Southern Natural Gas Co.	219	G 17,920	85,096	8/9/59
Southern Natural Gas Co.	299-300	G 17,156	83,233	5/13/59
Southern Natural Gas Co.	301	G 17,267	28,398	5/18/59
Tennessee Gas Trans. Co.	3-30-43	G 20,542	12,722	-
Tennessee Gas Trans. Co.	(Oper.) et al 20	G 20,543	5,698	-
Tennessee Gas Trans. Co.	(Oper.) et al 29	G 17,136	9,078	6/1/59
Tennessee Gas Trans. Co.	(Oper.) et al 34	G 17,086	3,161	6/1/59
Tennessee Gas Trans. Co.	36-209-231	G 17,280	64,776	6/1/59
Tennessee Gas Trans. Co.	39	G 17,139	3,025	6/1/59
Tennessee Gas Trans. Co.	200	G 17,277	3,604	6/1/59
Tennessee Gas Trans. Co.	(Oper.) et al 218-246	G 16,600	181,125	-
Tennessee Gas Trans. Co.	(Oper.) et al 218	G 18,414	14,687	10/7/59

PHILLIPS PETROLEUM CO., SECTION 4-e RATE SUSPENSION PROCEEDINGS NOT CONSOLIDATED WITH DOCKET NO. G 1148 ET AL AND PENDING AS OF SEPTEMBER 28, 1960

Purchaser	Rate Schedule No.	Docket No.	Annual Amount Suspended	Effective Subject to Refund
Texas Eastern Trans. Corp.	2-A	G 11,309	6,441	4/1/57
Texas Eastern Trans. Corp.	2-A	G 13,419	5,617	4/1/58
Texas Eastern Trans. Corp.	2A-275-281	G 20,255	17,369	-
Texas Eastern Trans. Corp.	2A-286	G 16,625	6,608	4/1/59
Texas Eastern Trans. Corp.	286	G 13,398	191	4/1/58
Texas Eastern Trans. Corp.	286	G 19,581	31	-
Texas Eastern Trans. Corp.	2A	RI60-367	7,100	
Texas Gas P/L Corp.	145	G 11,326	1,308	4/1/57
Texas Gas P/L Corp.	145	G 13,420	2,291	4/1/58
Texas Gas P/L Corp.	145	G 17,137	2,068	5/4/59
Texas Gas P/L Corp.	145	G 19,950	35,151	-
Texas Gas Trans. Corp.	202	G 11,991	34,082	7/15/57
Texas Illinois Nat. Gas P/L Co.	41	G 12,685	22,813	11/9/57
Transcontinental Gas P/L Corp.	149-220	G 17,740	85,940	7/9/59
United Fuel Gas Co.	273	G 14,260	61,902	5/16/58
United Fuel Gas Co.	273	G 16,712	43,435	4/1/59
United Fuel Gas Co.	273	G 20,013	135,337	-
United Gas P/L Co.	216	G 20,352	167,659	-
West Lake Natural Gasoline Co.	316	G 15,994	535	8/25/58
West Lake Natural Gasoline Co.	316	G 20,349	3,092	-
West Lake Natural Gasoline Co.	316	RI60-390	3,100	
			22,050,574	

Source: Federal Power Commission Records

* * * * * * * * * * *

32897

Order Denying Applications for Rehearing, Amending Opinion and Rejecting Application for Rehearing

(Issued November 25, 1960)

Under the provisions of Section 19(a) of the Natural Gas Act applications for rehearing have been filed with respect to the Commission's opinion and order No. 338, issued September 28, 1960. Timely applications were filed by Minneapolis Gas Company, the State and the Public Service Commission of Wisconsin, the Michigan Public Service Commission, Public Service Electric and Gas Company, the State and Public Utilities Commission of California and the Eastern Seaboard Companies.[1] An application for rehearing was filed by the Public Service Commission of New York, but it arrived after the termination of the statutory period within which such applications may be filed. A response to the applications for rehearing was filed by Phillips, and reply was made by the Eastern Seaboard Companies but we rejected Phillips response. A number of the points raised by the applications for rehearing have been sufficiently answered in the original opinion and needn't be discussed again. The principal points raised by the applications concern our authority to terminate these proceedings.

Minneapolis Gas argues that we have no authority to terminate the Section 5(a) investigation and Section 4(e) proceedings without making any finding as to the justness and reasonableness of Phillips' rates. We did not make such a finding because we did not believe we were supported by the record in doing so, and we were of the opinion that the public interest

[1] Long Island Lighting Company, Philadelphia Electric Company, and the United Gas Improvement Company.

did not justify our continuing these proceedings. In the first place we are given discretion as to whether to initiate proceedings either under Section 5(a) or Section 4(e). Section 5(a) provides that "Whenever the Commission, after a hearing had upon its own motions or upon complaint . . . shall find that any rate . . . is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate. . ." Under Section 4(e), relating to rate filings, "Whenever any such new schedule is filed the Commission shall have authority, either upon complaint . . ., or upon its own initiative without complaint . . . to enter upon a hearing concerning the lawfulness of such rate, . . .".

Just as the statute leaves us with discretion as to whether to initiate proceedings, we have authority to discontinue the proceedings. Regulation under the Natural Gas Act is carried on in the public interest (Section 1(a)), and there is no obligation to continue these proceedings to the point of making a definitive finding with respect to Phillips' rates, where the public interest is not served. Section 16 provides, "The Commission shall have power to perform any and all acts, and to prescribe, issue, make, amend, and rescind such orders, rules, and regulations as it may find necessary or appropriate to carry out the provisions of this act." We may now turn again to the basis for terminating these proceedings.

As we stated in our opinion, on the basis of the record and the test year 1954, we cannot reach a decision on cost of service applicable to the years after the issuance of our opinion and order. The Eastern Seaboard Companies argue that we should grant rehearing, consolidate all of Phillips' Section 4(e) proceedings and direct Phillips to submit a 1959 cost of service determination based on Opinion No. 338 as well as revised rate schedules designed to return its

current costs. This, of course, would require reopening the record and the submission of completely new evidence. For the future it is our judgment that the interest of consumers and the exigencies of regulation will be better served in rate proceedings brought on an area basis rather than on an individual company basis. Therefore, we do not think it in the public interest to reopen these proceedings, to determine a cost of service on the basis of completely new evidence and to attempt to determine rates on the basis of Phillips' individual cost of service.

The basis of our decision to terminate the dozen Section 4(e) dockets was that the rates filed in those dockets produced less revenues than the cost of service determined in our opinion. The fact that some of these rates are in excess of the average cost of service determined by us is immaterial. Phillips' rates would normally vary greatly because the sales are made at widely separated points and under different conditions, and there is nothing to show that these rates are discriminatory or preferential. In our judgment there is little or nothing to be gained for the consumer by continuing a complicated proceeding so as to determine just and reasonable rates for Phillips when it is already known that Phillips was not earning

its whole cost of service. To conclude, the attempt here to regulate Phillips' rates on an individual company basis has proved cumbersome and inexact. It has demonstrated however, that there is no public interest in continuing the Section 4(e) proceedings, which are largely concerned with past periods. Furthermore, because of the lapse of time, the 1954 cost of service determined by us is not appropriate for the future. The more recent rate increases filed with us have been suspended under Section 4(e), and they will be subject to the new area methods of regulation discussed in our Policy Statement. In this way we can proceed to a

more effective and expeditious regulation of the producer sales.

A few additional comments are appropriate on other points. Wisconsin objects to our including in the rate base $8,430,758 representing net investment in the San Juan Basin producing leases which were transferred to Pacific Northwest Pipe Line Corporation in November, 1955, after the end of the test year. We included these reserves because the record showed that they would be more than replaced after the test year, so that the San Juan Reserves did not abnormally inflate the test year rate base. Wisconsin argues that since we were not determining rates for the future it was inappropriate to include these reserves. We were not determining rates for the future as of the time of our opinion, but, we were determining a cost of service for the future from the standpoint of the test year. That is, our cost of service would apply to the test year 1954 and for a reasonable time thereafter.

Wisconsin also objects to our granting to Phillips a return of 11 percent on its rate base. It says that we are confusing the physical risk of producing gas with the financial risk assumed by investors. It adds that the physical risk is compensated for by the allowance of the cost of exploration development and production as an expense to Phillips in determining its cost of service. The financial risk, Wisconsin, in effect, says, is covered by the evaluation of the securities market as reflected in the earnings-price ratio, which we used as a factor in arriving at a fair rate of return. We do not think the situation is as simple as this. We must not only reflect past expenses in the cost of service and past risks in the rate of return, but as shown by our opinion, we must reflect the increasing expense and increasing risks of obtaining a gas supply. Therefore, as explained in our opinion, the use of 12 percent as an allowance for common equity and 11 percent for a fair rate of return was appropriate.

Wisconsin also objects to our reference to the spiral escalation clauses in Phillips' contracts as providing customer consent to Phillips' proposed rate increases. It may be recalled that these clauses provide for a contractual increase in Phillips' rates when its customer pipeline obtains an increase. Wisconsin says that they would purport to effect a change in rate between Phillips and its pipeline customers without compliance with Sections 4 or 5 of the Natural Gas Act and are therefore void as a matter of law. While the spiral clauses might change the contractual rights of the parties, Phillips can only change its rates by an appropriate filing under Section 4 of the Act.

32900

The Public Service Commission of the State of New York (PSC) has filed an application for rehearing which was mailed October 27, 1960, but was received by us on October 31, 1960, more than 30 days after the issuance of our Opinion No. 338, on September 28, 1960. Section 19(a) of the Natural Gas Act provides that aggrieved parties "may apply for a rehearing within thirty days after the issuance of such order." As interpreted in our Rules "An application for rehearing of a proceeding may be *filed* within 30 days after the issuance of any final decision or order by the Commission." (Section 1.34(a))[2] Therefore the application of PSC was not timely and must be rejected. Actually the application was directed to some of the same problems covered by the other applications for rehearing, particularly

[2] Section 1.14(a)(1) of our Rules provides:

"The filing of written applications, complaints, declarations, petitions, protests, answers, motions, briefs, exceptions, rate schedules, notices, reports, or other pleadings, amendments to pleadings, documents, or papers, with the Commission as required or allowed by these rules, by any rule, regulation, or order of the Commission, or by any applicable statute, shall be made by filing them with the Office of the Secretary of the Commission in Washington, D. C. Any such papers must be received by the Commission in Washington, D. C., within the time limit, if any, for such filing.

our decision not to determine Phillips' rates for the future, so that if we had accepted PSC's application for rehearing we would not have reached a different conclusion.

It has come to our attention that certain revisions should be made in the computation of Phillips' cost of service as set forth in appendices 9 and 10. To effect these revisions, amended appendices 9 and 10 are attached herewith. The purpose of the revisions is to correct the computation, to make explicit the treatment accorded the cost of raw gas, and to show gas used as compressor station and plant fuel gas separate from extraction losses and the treatment of its cost. The new computation in appendix 9, like the previous one,[3] shows the total gas produced and purchased amounting to 783,675,122 Mcf. This is divided, as before, on the basis of volumes into field sales and total gas gathered, the latter amounting to 687,145,852 Mcf. The total gas gathered on the basis of volumes is distributed to raw gas sales in the amount of 18,845,896 and residue gas sales from the system in the amount of 573,436,146, leaving 62,581,197 Mcf representing the loss involumes from the extraction of the liquids, residue returned to leases and gas vented, and 32,282,613 Mcf representing compressor station and plant fuel and unaccounted for gas. Conversion is

then made into Btu's using 1151 Btu's per cubic foot for the gathered gas and 1063 Btu's per cubic foot for the residue gas. From the Btu figures obtained, percentages are derived showing that of the gas gathered, after subtraction of the raw gas sales, 16.7328 percent is allocable to extraction losses etc. and 83.2672 percent is allocable to residue gas sales.

These percentages are employed in appendix 10 in computing the cost of service as described in our opinion.[4] As

[3] See our previous opinion, mimeo. p. 35.

revised we arrive at a jurisdictional cost of service of $54,525,315 or 11.1009 cents per Mcf, subject to redetermination for purchased gas costs, gathering taxes and royalties.

The Commission further finds:

The assignments of error and grounds for rehearing in the above applications for rehearing set forth no new facts or principles of law which were not fully considered by the Commission when it issued its opinion and order September 28, 1960, or which having now been considered warrant any change or modification of said order except as noted above. Such specifications of error, contentions and arguments contained in the above application for rehearing as are not specifically disposed of in the foregoing are without reasonable basis in law, or are immaterial to the correct decision of this case, and should be denied.

The Commission orders:

(A) The applications for rehearing filed by Minneapolis Gas Company, the State of Wisconsin and the Public Service Commission of Wisconsin, the Michigan Public Service Commission, Public Service Electric and Gas Company, the State and Public Utilities Commission of California and the Eastern Seaboard Companies are hereby denied.

(B) Our opinion and order is hereby amended by substituting $54,525,315 or an average of 11.1009 cents per Mcf representing the cost of service, subject to adjustment of purchased gas costs, gathering taxes and royalties for the amounts appearing in our opinion and order particularly on pages 49, 51, and 54 (finding clause 2) and by substituting the figures appearing herein relating to the allocation of costs between residue gas and liquids for those ap-

[4] See Mimeo., p. 49.

pearing in our opinion, particularly on page 35. The attached appendices 9 and 10 are hereby substituted for the prior appendices 9 and 10.

(C) The Application of the Public Service Commission of New York is hereby rejected.

By the Commission. Commissioner Kline concurring in the result. Commissioner Sweeney not participating.

32903

PHILLIPS PETROLEUM COMPANY

Gas Balance and Allocation Percentages
Year, 1954

Appendix 9 (Revised)
Docket No. G-1148, et al.

Description		Distribution of Production								Gas Sales From System		
			Less: Field Sales									
		MCF	Non-Jurisdictional	Jurisdictional	Total Gas Gathered	Raw Gas System Sales	Balance	Extraction Loss, Residue Returned To Leases & Vented	Residue Gas Sales From Systems	Total	Non-Jurisdictional	Jurisdictional
(1)		(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
Gas Produced												
Dry Gas	226,681,178											
Casinghead Gas	70,510,228											
Condensate Gas	75,499,506											
Total		375,690,912	31,370,014	65,159,256	279,161,642							
Percent		100.0000	8.3500	17.3438	74.3062							
Gas Purchased												
Outside leases	336,373,922											
Outside Interest in Phillips Leases:												
Dry Gas	38,694,495											
Casinghead & Condensate Gas	32,915,793											
Total		407,984,210	.....	.....	407,984,210							
Total Produced & Purchased		783,675,122	31,370,014	65,159,256	687,145,852	18,845,896	668,299,956					
Compressor Station & Plant Fuel and Unaccounted For							32,282,613					
Sub-total							636,017,343	62,581,197	573,436,146	573,436,146		
						(18,845,896)	.....			18,845,896		
Total Gas Sales From Systems										592,282,042	166,262,345	426,019,697
Percent										100.0000	28.0715	71.9283
Btu (Per Cubic Foot)					1151	1151	1151	.....	1063			
Total Btu (Millions)					790,904,876	21,691,626	769,213,249	.....	.....			
Compressor Station & Plant Fuel and Unaccounted For							37,157,287					
Sub-total							732,055,962	122,493,339	609,562,623			
Percent					100.0000	2.7426	97.2574					
Percent							100.0000	16.7328	83.2672			

Summary of Jurisdictional Sales	*M.C.F*
Jurisdictional Sales From System	426,019,689
Jurisdictional Sales From Leases	65,159,256
Total Jurisdictional Sales	491,178,953

32904

PHILLIPS PETROLEUM COMPANY
Jurisdictional Cost of Service
Year 1954

Appendix 10 (Revised)
Docket No. G-1148, et al.

Description	Volume	Total Cost of Gas	Field Sales: Non-Jurisdictional	Field Sales: Jurisdictional	Delivered to Gathering Systems	Less Raw Gas System Sales	Balance	Extraction Losses, Returned to Leases & Vented	Total Cost of Residue System Sales	Cost of Sales from Systems: Total	Cost of Sales from Systems: Non-Jurisdictional	Cost of Sales from Systems: Jurisdictional
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)
						Col.(6)x2.7426%		Col.(8)x16.7328%	Col. 8-Col. 9			
Percent		100.0000	8.3500	17.3438	74.3063					100.0000	28.0715	71.9285
Cost of Gas Production & Exploration												
Direct and Allocated	376,690,912	$ 37,924,378	$ 3,166,686	$ 6,577,528	$ 28,180,164							
Purchased Gas	407,984,210	30,320,225	.....	.....	30,320,225							
Total		$ 68,244,603	$ 3,166,686	$ 6,577,528	$ 58,500,389	$ 1,604,432	$ 56,895,957	$ 9,520,287	$ 47,375,670	$ 47,375,670		
Gathering System & Compressing Facilities		18,452,321			18,452,321	506,073	17,946,248	3,002,910	14,943,338	14,943,338		
Residue System		1,674,725			1,674,725		1,674,725	.....	1,674,725	1,674,725		
Sub-total		$ 88,371,649			$ 78,627,435	$ 2,110,505	$ 76,516,930	$ 12,523,197	$ 63,993,733	$ 63,993,733		
Raw Gas Sales						(2,110,305)				2,110,505		
						$						
Total										$ 66,104,236	$ 18,556,451	$ 47,547,757

Summary of Jurisdictional Cost of Service

Jurisdictional Sales From Systems Col. (13)		$ 47,547,787
Jurisdictional Sales From Leases Col. (5)		6,577,526
Regulatory Commission Expense		400,000
Total Jurisdictional Cost of Service		$ 54,525,315
	Cost For M.C.F	
$ 54,323,315	$491,178,953	11.1009¢

* * * * * * * * * *

32909

UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 11247

STATE OF WISCONSIN and PUBLIC SERVICE COMMISSION OF WISCONSIN, *Petitioners*

v.

FEDERAL POWER COMMISSION, *Respondent*

* * * * * * * * * *

32911

Before EDGERTON, CLARK, and PRETTYMAN, Circuit Judges.

EDGERTON, *Circuit Judge:*

* * * * * * * * * *

32919

Phillips urges that the Commission's findings are supported by substantial evidence and should therefore be sustained. But the validity or invalidity of the Commission's conclusion that Phillips is not a "natural-gas company" does not turn upon the evaluation of testimony or upon any facts peculiar to this case. It turns upon the generic question whether the exemption of "production or gathering" in § 1(b) of the Natural Gas Act covers interstate sales of gas by the corporation that produced and gathered it. We think the Act and the decisions of the Supreme Court permit only one answer. We think the Commission has applied an erroneous rule of law. Phillips' sales to the pipeline companies are not within either the statutory phrase "the production or gathering of natural gas" or the Supreme Court's paraphrase "made during the course of production and gathering". Therefore Phillips is a "natural-gas company" within the meaning

of the Natural Gas Act and the Commission should fix the rates at which these sales are made.[14]

Reversed

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32929

Before: Edgerton, Clark and Prettyman, Circuit Judges

JUDGMENT AND DECREE—Filed May 22nd, 1953

These cases came on to be heard on the transcript of the record from the Federal Power Commission, and were argued by counsel.

On consideration whereof, It is ordered, adjudged and decreed by this Court that the order of the said Federal Power Commission on review herein be, and the same is hereby, reversed, and that these cases be, and they are hereby, remanded to the Federal Power Commission for further proceedings in conformity with the opinion of this Court.

Per Circuit Judge Edgerton.

Separate dissenting opinion by Circuit Judge Clark.

* * * * * * * * * * *

[14] The Commission expressly recognizes that its decision to the contrary is subject to review.

32931

Docket No. G-1148

In the Matter of

PHILLIPS PETROLEUM COMPANY

Order Vacating Termination of Proceedings and Continuing Investigation

The Commission in its opinion issued August 22, 1951,[1] found, among other things, that Phillips Petroleum Company (Phillips) is not a natural-gas company within the meaning of Sections 1(b) or 2(6) of the Natural Gas Act, and by order accompanying that opinion the Commission terminated the proceeding initiated by its order issued October 29, 1948, in this docket, instituting an investigation to determine whether Phillips is a natural-gas company and, if so, whether in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, any rates, charges, or classifications demanded, observed, charged or collected, or any rules, regulations, practices or contracts affecting such rates, charges or classifications are unjust, unreasonable, unduly discriminatory, or preferential.

The United States Court of Appeals for the District of Columbia Circuit handed down its opinion[2] reversing the Commission and determined that Phillips is a natural-gas

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1 *In the Matter of Phillips Petroleum Company*, Docket No. G-1148, Opinion No. 217 and accompanying order, 10 F.P.C. 246, 283.

2 *State of Wisconsin* v. *F.P.C.*, 92 U.S. App. D.C. 284, 205 F. 2d 706.

company and that the "Commission should fix the rates" for Phillips' sales of natural gas for resale in interstate commerce. On June 7, 1954, the United States Supreme Court affirmed the opinion of the Court of Appeals.[3]

The judgment and decree of the Court of Appeals remanded the matter to the Commission for further proceedings in conformity with that Court's opinion.

32932

The Commission *finds:*

It is necessary and proper in the public interest, to aid in the enforcement of the Natural Gas Act, and in compliance with the mandate of the Court of Appeals, that our termination of the proceedings in this docket be vacated and that the investigation initiated by our order issued October 29, 1948, with respect to Phillips' rates and charges be continued.

The Commission *orders:*

(A) The termination of the proceedings in this docket directed by our order issued August 22, 1951, be and the same hereby is vacated.

(B) The investigation of Phillips Petroleum Company instituted by our order issued October 29, 1948, be and the same hereby is reinstituted and continued for the purpose of enabling the Commission to determine whether in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, any rates, charges, or classifications demanded, observed, charged or collected by Phillips, or any rules, regulations, practices or contracts affecting such rates, charges, or classifications

[3] *Phillips Petroleum Co.* v. *Wisconsin, et al.*, 347 U.S. 672.

are unjust, unreasonable, unduly discriminatory, or preferential.

(C) If the Commission shall find, after hearing, that any of Phillips' rates, charges, classifications, rules, regulations, practices, or contracts, subject to the jurisdiction of the Commission, are unjust, unreasonable, unduly discriminatory or preferential, it shall determine and fix, by order or orders, just and reasonable, nondiscriminatory and nonpreferential rates, charges, classifications, rules, regulations or contracts to be thereafter observed and in force.

By the Commission.

Adopted: November 17, 1954
Issued: November 22, 1954

[fol. 410]

IN UNITED STATES COURT OF APPEALS

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 16175

STATE OF WISCONSIN and PUBLIC SERVICE COMMISSION OF WISCONSIN, Petitioners,

v.

FEDERAL POWER COMMISSION, Respondent,
PHILLIPS PETROLEUM COMPANY, Intervenor.

No. 16177

LONG ISLAND LIGHTING COMPANY, et al., Petitioners,

v.

FEDERAL POWER COMMISSION, Respondent,
PHILLIPS PETROLEUM COMPANY, PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK, Intervenors.

No. 16180

PEOPLE OF THE STATE OF CALIFORNIA and PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, Petitioners,

v.

FEDERAL POWER COMMISSION, Respondent,
PHILLIPS PETROLEUM COMPANY, Intervenor.

[fol. 411]

On Petitions for Review of Order of the Federal Power Commission

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OPINION—Decided November 30, 1961

Mr. William E. Torkelson for petitioners in No. 16175.

Mr. J. David Mann, Jr., with whom Messrs. John E. Holtzinger, Jr., William W. Ross, and David K. Kadane were on the brief, for petitioners in No. 16177.

Mr. William M. Bennett for petitioners in No. 16180.

Mr. Arthur H. Fribourg, Attorney, Federal Power Commission, with whom Mr. John C. Mason, General Counsel, Federal Power Commission, at the time the brief was filed, and now Deputy General Counsel, and Mr. Howard E. Wahrenbrock, Solicitor, Federal Power Commission, were on the brief, for respondent.

Mr. Kenneth Heady, of the bar of the Supreme Court of Oklahoma, *pro hac vice*, by special leave of court, with whom Messrs. Charles E. McGee and Lambert McAllister were on the brief, for intervenor Phillips Petroleum Company.

Messrs. Kent H. Brown and George H. Kenny and Mrs. Barbara M. Suchow were on the brief for intervenor Public Service Commission of the State of New York in No. 16177.

Before Prettyman, Fahy and Danaher, Circuit Judges.

PRETTYMAN, Circuit Judge: Some controversies concern major problems of general application. Others concern only a limited set of circumstances. The case at bar is of the former variety. The questions are posed by complicated procedural difficulties. They concern the procedures of the Federal Power Commission in dealing with the rates of natural gas producers.

[fol. 412] The Phillips Petroleum Company is a producer of natural gas. It procures gas from several widely separated and widely differing areas. It explores for, develops, produces, purchases, gathers and processes gas and oil. It sells gas to pipeline companies[1] under contracts negotiated by it and these customers. The contracts differ in such terms as delivery conditions, water content, hydrocarbon content, place of delivery, pressure, and price.

[1] It also sells oil, products condensed from gas, and other petroleum products and chemicals. It sells natural gas in several conditions. It sells to customers other than pipelines as well.

Two sections of the Natural Gas Act[2] are involved. One (Section 4(e)) provides in essence, as to sales subjected to regulation by the Commission, that when a rate or an increased rate is filed the Commission may suspend it for five months, meantime setting it for hearing. When such a rate goes into effect after the period of suspension (the Commission not having concluded its consideration), the funds derived from the newly-filed rates may be impounded and, in so far as the Commission fails to approve them, may be refunded. The burden of proving in such a proceeding that an increased rate is "just and reasonable" rests upon the company. The other section of the statute (5(a)) provides in essence that either upon a complaint or upon its own motion the Commission may inquire into an existing rate. If that rate be found unlawful the Commission must determine what shall thereafter be deemed a just and reasonable rate. Its decision becomes effective from its date. No refund is involved.

In October, 1948, the Commission instituted a proceeding [fol. 413] under Section 5(a), the latter of the above sections, concerning Phillips's rates. In that proceeding it decided it had no jurisdiction over the rates of producers of natural gas. This court reversed the Commission,[3] and the Supreme Court affirmed our decision.[4] The Commission reinstated its 5(a) proceeding.

Meantime and thereafter Phillips filed increased rates in respect to many of its contracts. The Commission suspended them and set them for hearing, under Section 4(e) of the statute, the first of the two sections above discussed. Many purchasers, many contracts, many rate schedules, and many filings were involved. Thus many 4(e) proceedings, under different docket numbers, were instituted. As time went on, Phillips filed further proposed increases in some of these same rates. In such event the earlier proposed rate would, if approved, cover a limited period, *i.e.*, until the

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[2] 52 STAT. 821 (1938), as amended, 15 U.S.C. §§ 717-717w.

[3] State of Wisconsin v. Federal Power Comm'n, 92 U.S. App. D.C. 284, 205 F.2d 706 (1953).

[4] Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954).

succeeding increase in that same contract rate was filed. A period thus limited is called a "locked-in period" in the jargon of the industry. These later increases were also suspended by the Commission. Thus many proceedings under Section 4(e) involving rates of Phillips became pending.

The Commission consolidated the 5(a) proceeding and twelve of the 4(e) proceedings for hearing. These twelve 4(e) proceedings involved an aggregate of about five and a half million dollars in proposed increased rates. The proposed rates ranged from 5¼ cents per Mcf to 13½ cents per Mcf. The proceeding was long, detailed and resulted in a voluminous record of testimony and exhibits. The Examiner rendered a long (174 printed pages), careful and complete initial decision. He approached the prob-
[fol. 414] lem from the standpoint of cost-of-service[5] and rate base. Many perplexing problems were presented. He examined them all and decided them. Among them were different approaches to cost-of-service, the allocation of production costs, the allocation of exploration costs, the problem of natural gas liquids, the rate base, adjustment to the test year, the computation of the income tax component, the proper rate of return, working capital, allocations between jurisdictional and non-jurisdictional sales, field prices, a discussion of system-wide as compared with area rates. Upon all these the Examiner made detailed findings and conclusions, displaying commendable patience and grasp of the subject matter. He adopted a system-wide approach and found that Phillips's total jurisdictional cost of service, properly computed, was $57,280,218 for the test year,[6] or an average unit cost of 11.662 cents per Mcf. He recommended that Phillips be ordered to calculate a maximum rate for gas with certain described qualities at such level that, when applied to the sales volume for all jurisdictional contracts, adjusted for approved delivery condition differentials, would produce revenues roughly equal to the system-wide cost of service. He recommended

[5] Cost-of-service in this context includes not only operating expenses, taxes, exploration allowances, and gas purchases but also a fair return on the rate base.

[6] Compared with 92.3 million dollars claimed by Phillips.

that Phillips be ordered to file, with full explanations, a list of rates so calculated. These calculated rates would be subject to approval by the Commission. He recommended that the rates thus calculated and approved be applied in both the 4(e) and the 5(a) proceedings, *i.e.*, to both suspended and future rates.

The Commission reversed the Examiner. Its decision and findings were also extended and exhaustive (82 printed pages, plus exhibits). One Commissioner dissented in re-
[fol. 415] spect to the computation of the cost of service; otherwise he concurred. Basically, the Commission concluded "beyond any doubt, that the traditional original cost, prudent investment rate base method of regulating utilities is not a sensible, or even a workable method of fixing the rates of independent producers of natural gas." It pointed out critical differences between pipeline operations and producer operations, quoting from opinions by Mr. Justice Harlan and Mr. Justice Jackson, and saying that in regulating producers it is faced with problems entirely different from those of an ordinary public utility. It pointed out that simply to allow producers a return on investment would penalize the efficient or fortunate and reward the inefficient or unfortunate. Only where a producer purchases a fully developed acreage at a fair price does his investment have a real relationship to his return. The producer who first takes the risk in an area and proves it productive pays less for his rights than those who come later. But he must invest his funds before he knows whether he will have anything to sell or not. Mr. Justice Jackson once wrote that "there is little more relation between the investment and the result than in a game of poker."

The Commission pointed out that a producer of natural gas also produces oil, the price of which is unregulated, makes sales (intrastate, etc.) not subject to Commission jurisdiction, and sells products also excluded. Thus "extremely difficult" problems of allocating costs are involved. It commented that none of the experts proposed allocations acceptable to other experts. "Ridiculous results will be reached among the great number of producers and owners of interests if costs should be the only basis for regulation." It referred to the fact that much of Phillips's

gas is purchased from thousands of independent producers whose rates are under percentage-type casinghead contracts, dependent on Phillips's rates. The interests of the [fol. 416] many royalty owners must also be considered. Another problem is the administrative burden of full cost rate cases for each of thousands of independent producers. Adherence to cost rate-base methods results in necessity for a full-scale company-wide cost study to determine the proper price in any one contract. At the time of this Commission decision 3372 independent producers had rates on file. Five hundred seventy producers were involved in 3278 proposed rate increases under suspension and awaiting hearing. Of eleven rate increase cases in which full hearings had been had and decisions rendered, ten showed the increases justified. A special problem prevented decision in the other. In the three 5(a) cases theretofore completed, the producers' prices were found justified. Rigid adherence to the rate-base method would in many cases price the producers' gas out of the market. "From the foregoing, it follows that effective regulation of the price of natural gas must be on some more manageable plan than the rate base method. Thus it is clear that the better method would be to establish fair prices for the gas itself and not for each individual producer."

Simultaneously with the foregoing opinion the Commission promulgated a "policy statement" setting forth rate guidance schedules for various producing areas. These schedules consisted of two rates prescribed for each of twenty-three producing areas throughout the country (except for two areas, for which only one rate was given). One rate was for initial service, *i.e.*, new contracts, in the area. The other was for increases in rates, *i.e.*, proposals for increases in existing contracts, in the area. For example, in the first area listed (Texas District No. 1) an initial service rate of 15.0 cents per Mcf was given and an increased rate level of 14.0 cents per Mcf. The Commission described its preparation of these schedules thus:

> "In arriving at the price levels for the various areas set forth in the appendix to this statement, we have [fol. 417] considered all of the relevant facts available to us. Such consideration included cost information

from all decided and pending cases, existing and historical price structures, volumes of production, trends in production, price trends in the various areas over a number of years, trends in exploration and development, trends in demands, and the available markets for the gas. Of necessity, we have not set forth the adjustments to these prices which must be made to take into account every possible provision of every contract which may affect the actual price, such as Btu adjustments, conditions of delivery, etc. The relevance of such adjustments to the basic contract price and the appropriate established price standard must be considered as each filing is made."

The proposed use of this list was described by the Commission as follows:

"* * * * These standards will serve as a guide to us and to interested parties in determining whether proposed initial rates should be certificated without a price condition and whether proposed rate changes should be accepted or suspended.

* * * * * * *

"These price levels, as announced by Appendix A attached to this statement, are for the purpose of guidance and initial action by the Commission and their use will not deprive any party of substantive rights or fix the ultimate justness and reasonableness of any rate level."[7]

In its opinion the Commission said further: "This schedule of prices is only for guidance and does not constitute any determination of just and reasonable rates and will not foreclose any person from justifying a particular rate in any area." The schedule is of maximum acceptable rates for gas from a given area, as opposed to rates [fol. 418] established for each rate filing by each producer after a full cost-rate base consideration of each rate so filed.

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[7] Statement of General Policy No. 61-1, Sept. 28, 1960, 25 Fed. Reg. 9578 (Oct. 5, 1960).

The Commission disposed of the consolidated cases before it in three parts. The first part consisted of the superseded rates of the prior periods ("locked-in" periods). The second consisted of the presently current rates and those to be in effect during the interim period from now until the newly proposed area-rate system is completely designed and put into effect. The third part consisted of rates for the future after the completion and inauguration of the area-rate system.

Before we consider these several dispositions in detail we must understand the problem with which the Commission was dealing. The rates proposed to be increased in these 4(e) proceedings[6] are not the rates of utilities in the traditional sense, such as pipelines. The rates here involved are the charges made by companies which buy or produce a product, process it to suit the requirements of a customer, and sell it to that customer under a contract. The product is procured from many different places, from Texas to West Virginia, from Louisiana to Wyoming. In its raw state it is of many different contents. Different customers require different terms as to the physical qualities of the delivered article, points and terms of delivery, and other factors. Hundreds of producers, hundreds of contracts, and thousands of rate filings are involved.

When we use the terms "cost of service" or "rate base" in this context, we must be careful of the meaning we intend. There is a system-wide cost of service. This would be, as the words indicate, a computation for the entire Phillips system. But even so it would not be a computation for all Phillips operations, because the Company has many operations, such as those in petro-chemical fields, and sales of all sorts of petroleum products, and many sales not [fol. 419] subject to federal regulation under present statutes. In fact the Company's gross income from sales of natural gas in 1955 was less than six per cent of its total gross income. So even a system-wide computation of cost of service for sales of natural gas subject to Commission regulation requires monumental allocations of many costs, such as exploration costs, taxes, administration expenses, purchases, extraction costs, sales of residue gas and liquids, and so on. Nevertheless such a computation was made.

The Examiner and also the Commission determined and used a system-wide cost of service. As found by the Commission the system-wide cost of service for Phillips's sales of natural gas subject to Commission jurisdiction in the test year 1954 was $55,548,054, or 11.309 cents per Mcf. But even the figure thus carefully computed was subject to adjustment for purchased gas costs, gathering taxes, and royalties. The same observations apply to the rate base on a system-wide basis. One was determined by the Commission.

Then, theoretically at least, there is a cost of service for each contract, if not for each rate, and so for each 4(e) proceeding. But nobody, so far as we are advised, contends that any such computations could be made with any meaningful results by any known method. The results of any such effort would be pure guesswork, involving a vast multiplication of the arbitrary allocations which would have to be made.

The Examiner did not attempt to make any cost-of-service determination on individual contract, rate, or case basis. He determined a system-wide cost of service, which gave him a nationwide average unit cost of 11.662 cents per Mcf. He then proposed that '[b]ased on the system-wide cost of service herein approved, as set forth in Appendix Table 12 hereof, Phillips shall calculate the 'maximum rate for 1,000-pound, sweet, dehydrated, and [fol. 420] gathered gas,' at such level that its application to the sales volumes delivered in 1954 under each and every one of the 1954 jurisdictional contracts, as adjusted for the approved delivery condition rate differentials, will produce total revenues roughly equal to such system-wide cost of service." He proposed further that "Phillips shall file with the Commission a statement of such 'maximum rate,' including a clear and detailed explanation as to the manner in which it was calculated, together with a list of *calculated rates* for all of its jurisdictional rate schedules then in effect." The Commission, as we have said, reversed the Examiner, treating the case, in effect, in three parts.

1. As to the first part of the problem, the 4(e) proceedings, dealing with suspended proposals now super-

seded, the Commission made system-wide conclusions as to jurisdictional sales and applied them to these cases. It found $45,568,291 of revenues against $55,548,054[8] cost of service. This showed a system-wide deficit of some $9,000,000 on jurisdictional sales of natural gas. The Commission noted that no evidence had been presented to show that the different rates in these different (4(e)) proceedings were unduly discriminatory or preferential, which notation, translated, means that any adjustment in these rates should be correspondingly proportionate in respect to each and all. The Commission applied the result of its system-wide calculations to each and all of the 4(e) proceedings and concluded that no refunds were due. Having thus ordered, it concluded ("terminated") the proceedings.

The Commission made no determination of the cost of service of each of these contract rates separately; it had no evidence before it upon which it could make such de- [fol. 421] terminations, and it was of opinion that such computations would be unworkable and foolish under the circumstances.

In these 4(e) cases, as we have pointed out, the Commission was dealing with a locked-in period. The revenues derived from the rates at issue had been impounded. The only question of substance in respect to that period was whether refunds should be made. The Commission decided that question, flatly and directly. No other question remained in those cases for decision. They presented no questions as to rates to be charged. Each presented the question whether a refund was due that customer for that past period and, if so, how much. Having made three determinations—(1) that there was a deficit of some $9,000,000 a year in revenues against cost of service, (2) that the increases involved totaled about five and a half million dollars and so, if allowed in full, would not wipe out the operating deficit, and (3) that any adjustments should be proportionate to all contract rates—it concluded that no refund was due on any contract, *i.e.*, in any 4(e)

[8] Modified to $54,525,315 after rehearing.

proceeding. Section 4(e) pertinently says that the Commission "may" order a refund of "the portion of such increased rates or charges by its decision found not justified." We cannot say that a deficit justifies or requires a refund or that the Commission was unlawfully arbitrary in reaching that result from the premises.

We think the Commission's course was reasonable and tenable. Surely, if only a single rate had been involved, and enough evidence were introduced to justify, under testing, a conclusion that the company was operating at a deficit under that rate, it would not be necessary that evidence be taken to establish the precise penny amount of the deficit in order to support a reasonable inference by the Commission that no refund was indicated. Of course, in the matter at bar a number of rates in separate cases were involved, but the principle of procedure and [fol. 422] the scope of permissible inferences from basic facts are much the same as in the suggested illustration. We think the facts support the conclusion.

It is argued that the Commission did not declare the rates under consideration to be just and reasonable or the contrary; that, instead, it "terminated" the proceeding. The contention is that the Commission made no decision. We think the point is not well taken. The Commission did make a clear decision, after elaborate findings, upon the one substantive issue before it. It did say it "terminated" the proceedings, but it terminated them after deciding the basic and dispositive issue, and it entered an order on that decision. Its "termination" was much like that of a judge after he has rendered findings, conclusion and judgment.

Whether the Commission should have preceded its ultimate conclusion of no-refund with an intermediate conclusion of justness and reasonableness in the rates at issue, and whether it properly added the termination order to its decisive finding, seem to us to be immaterial queries. The important feature is that the Commission reached and decided the critical substantial issue, rationally and upon detailed findings of basic facts upon an ample record.

This is not a *Minneapolis Gas*[9] situation, in which the Commission did nothing but simply terminated the proceeding without passing upon any of the disputed issues before it.

2. The case yields to clearer treatment if we next consider the part of the Commission's treatment which is last in chronological order, that is, the determination of rates [fol. 423] for the future. As to these rates the Commission embarked upon the formulation of a new method of fixing just and reasonable rates for producers. It inaugurated hearings for that purpose. We think we need not explore the possibilities of success in that venture, or stop here to describe the projected scheme previously outlined in this opinion. In general it is referred to as an area-price method; it aims to establish proper prices for the gas rather than for the seller thereof. The Congress has confided the regulation of the natural gas industry to the Commission, not to the courts. The Supreme Court has said several times that the Commission is not bound to any one method or to known methods. The regulation of gas producers is a new project. Obviously, as is cogently pointed out in this record, it presents new and complex facts and problems. It would be foolish for the courts to hold that the Commission is bound to apply to these new conditions the methods and measurements designed and used for other and different regulatory purposes. We think it is clear that the Commission had ample authority to embark upon an effort to design suitable new standards for use in the regulation of producers when it found that the tools at hand were not suited to this purpose. The Commission abandoned the pending 5(a) proceeding in which it had been endeavoring to establish rates for the future by methods it now deems inadequate. We see no reason why it should not have done so.

3. The difficult part of the case before us concerns the second, or middle, part of the Commission's disposition. This involves the rates for the period from 1959 until the

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[9] Minneapolis Gas Company v. Federal Power Commission, —— U.S. App. D.C. ——, 294 F.2d 212 (D.C.Cir. 1961).

new system—or a new system—is designed and established. This period will be long, estimates running from four to fourteen years. The rates during this period may, theoretically, be (1) rates in effect without increases having been proposed after January 1, 1959, (2) rates proposed to be increased since that date and suspended under Sec- [fol. 424] tion 4(e), (3) rates for which increases may be proposed after the present time; (4) initial rates, *i.e.*, rates under new contracts made after January 1, 1959.

To meet the need for interim regulation the Commission took several steps. It published the policy statement which we have described. That announcement contained several components. First, the Commission said that in determining its own *sua sponte* action in respect to rates (*i.e.*, suspending proposed increases or inaugurating inquiries into existing rates) it would be guided by the guide rates. Second, it said that persons attacking rates (*i.e.*, customers and consumers) would be required to present evidence as to the industry generally in the area concerned, as well as the traditional evidence relating to the individual producer involved. Third, it said that "[a]s experience and changing factors may indicate," it would change the areas designated and likewise change the guide prices. Fifth, it said it will use its guide rates in disposing of 4(e) (*i.e.*, suspended proposed increases) proceedings arising upon increases proposed since January 1, 1959.

Refraining from exploring the various arguments, and argumentative trails, pointed out to us by the parties, we come directly to the crux of this problem. Has the Commission power under the Natural Gas Act to do what it did? Can it adopt upon the basis of its own expertise and its files, without a record made in the open in respect to the specific subject matter in issue, and without hearing, a set of guide lines by which it will be controlled in its regulatory functions during an interim period while it is attempting to perfect a suitable system for permanent regulation? We think it can.

In the first place, and throughout, we must remember that the Congress has power to direct the regulation of interstate commerce, and it has placed that regulatory

[fol. 425] power over natural gas in the Power Commission. We must remember that the problem at bar concerns a regulatory power. We are not considering adjudicatory, or quasi-judicial, power. It has long since been established that rate-making is a legislative function, and it is so defined in the Administrative Procedure Act.

Regulation poses many difficult problems. New regulation poses acutely difficult problems. Solutions oftentimes develop slowly. Many illustrations of that fact could be called to mind.

What power has the Commission in respect to interim regulation while the permanent structure is being designed and erected? Must it use means and methods long established for use in respect to other and different regulatory necessities? Or may it design from its own judgment and accumulated data a new method designed for the new problem? The difference between a public utility, such as a pipeline rendering a service by means of a fixed plant and operation, and a producer, who discovers or buys a product where, when and under such terms as he may, and sells that product under contracts negotiated on the open market, are too evident to justify elaboration. Whether the method thus designed and put into use by the Commission is good or bad is not part of our problem. Our inquiry is whether it was within the orbit of statutory authority and whether it was within constitutional limitations. We turn to those questions.

The Natural Gas Act is broad in its bestowal of power. It declares that all rates demanded by a company in connection with the sale of gas in interstate commerce for resale shall be just and reasonable. Section 4(a). A gas company files with the Commission schedules of its rates. Section 4(c). If a company proposes to increase a rate, it must file a new schedule. The Commission may then enter upon a hearing concerning the "lawfulness" of the [fol. 426] proposed rate. Section 4(e). If the Commission, on its own motion or upon complaint, finds a rate unjust, unreasonable, unduly discriminatory or preferential, the Commission "shall" determine the just and reasonable rate. Section 5(a). Of course, constitutional restrictions apply; rates fixed by governmental authority cannot be confisca-

tory; all procedures must be by due process, that term conveying meanings differing according to the basic nature of the proceeding but always including that which is fair and decent according to the standards of our social order and time.

The statute contains no definition of a "just and reasonable" rate. It is established by tradition and by many court decisions that for a public utility, rendering service by use of fixed equipment, a just and reasonable rate is one which returns a fair profit upon the investment, or which supplies the utility with adequate revenues to command needed funds upon an economically reasonable basis. But what of a fair price for a commodity bought and sold by a merchandiser? Almost the whole of the economics of merchandising differs from the economics of public utility service. Are the just and reasonable prices of such a merchandiser limited to fair returns on his own investment and prices paid by him (and, if so, what investment and what prices), or are those prices reasonably measured by the fair prices for the product as measured by the open competitive market for the product, evaluated by Commission expertise and data on the whole of the market operation? Either criterion is a method of regulation. It seems to us that the choice must lie with the Commission.

Let us emphasize that we do not have before us at this time the question whether any rate set by the Commission as a guide rate falls within the area of reasonable computation. That question is emphatically left open [fol. 427] by the Commission, and by us, for consideration when some one or more of the selected guide rates is attacked, by a producer, a customer, or a consumer. The problem here at this time is merely whether the Commission may embark upon this method of regulation. Since it is the Commission's judgment that this method is best suited for the regulation of these prices, for the determination of their justness and reasonableness, we find in the statute nothing to deny a trial of the method.

Of course, conceivably, justness and reasonableness from the standpoint of the consumer might be defined as limiting the vendor's return to a fair amount on his investment, and his price accordingly. But, if the government

agency charged with the responsibility in the public interest finds, after elaborate accumulation of data, that such a measurement is unworkable, may not a fair price for the product reflected on the open market, after scrutiny and adjustment by the government agency concerning the factors which produced that price, be just and reasonable for the consumer? Of course the agency would be required to be alert for artificial impulses in such a fair area prjce, and the avenues of attack by consumers would have to be kept open without obstruction; but, if the latter is avowed, how could we assume in advance that the agency would not protect the consumer as it is charged by the Congress to do? The Commission is not here proposing to accept a field price, or any other price as is. It has announced guideline rates which it deems to be, on the basis of the internal data in its files on all the operators in the several areas, fair rates for the product in those areas. Such rates, thus determined, would seem to be just and reasonable rates for the consumers of the product. And, similarly, they would seem to be just and reasonable charges for the producers to make.

As to the constitutional question of confiscation, it [fol. 428] would seem to us that the question should await the proof presented by a producer in respect to a particular rate in a particular area.

Thus we come to conclude that the interim method of regulation proposed by the Commission does not appear at this point in the process to be violative of either statutory or constitutional limitations.

It is urged upon us that the Commission has abandoned regulation of these rates for this interim period. We do not agree with that view. It has certainly changed the method of regulation, or, more precisely, the standards by which it will apply its regulatory power. It has abandoned case-by-case, contract-by-contract measurements on a cost-of-service rate-base basis. It has installed an area fair price measurement for the prices of the product to be sold. In so doing it has abandoned a method it finds to be unworkable and foolish in favor of a method it deems to be workable and just and reasonable. If that be so, instead of abandoning regulation it is making regulation

effective. The choice it faced, at least in its own view, was not between regulation or no regulation but was between effective and ineffective regulation.

If, as some consumer interests fear, the new process turns out to be ineffective in the protection of their interests, the way is open for them to challenge the results; as we have pointed out, that way must be kept open. New rates and increases in rates proposed during this interim will be subject to suspension and refund, and so the rights of customers will be fully protected. The new method will also apply in 5(a) proceedings to any existing rate found to be unjust or unreasonable. Refunds cannot be ordered in the latter cases and so consumers bear the disputed rates during the period of the inquiry. But this same situation obtains in the present process of regulation; the application of the new criteria makes no change [fol. 429] in this procedural aspect. In the case at bar the Commission has found, after elaborate consideration, that present rates result in deficits to the Company. Consumers have no tenable ground for complaint of such rates. So it seems to us that the interests of consumers are amply protected during this interim period; at least a contrary effect should await the event for us to disturb the view of the Commission, based as it is upon this record.

There remains for discussion a point concerning two 4(e) proceedings which were not terminated. They involved proposed increases based upon escalator clauses in two of Phillips's contracts. These contracts were made before producers such as Phillips were subject to regulation. They were with pipeline companies, as customers, which were subject to regulation. The contracts provided that, if the pipeline companies were granted increases in the rates they could charge, Phillips in turn would receive increases in the rates it charged these customers. These customers had proposed increases, and they were pending in 4(e) proceedings. The Commission ordered that upon decisions in the customers' rate cases Phillips's cases would be acted upon.

Wisconsin and California contend that the Commission should now declare these escalator clauses to be illegal and void as against public policy. As a matter of fact the

Commission has declared these clauses to be against the public interest and that they should be held inoperative. But, the Commission says, in so far as these cases of Phillips are concerned, action of the sort demanded by Wisconsin and California is premature. Action on these clauses, it says, should await action on the pending cases which in orderly processes present the problem for decision. We agree with the Commission.

Affirmed.

[fol. 430] FAHY, Circuit Judge, dissenting, with partial concurrence: I am not able to agree that the order of the Commission terminating the section 4(e)[1] and section 5(a)[2] proceedings should be affirmed. I think the cases should be remanded to the Commission for decision.

While the Commission advances strong reasons for abandoning cost of service as a method of determining the justness and reasonableness of the rates of independent producers of gas, a careful reading of the Commission's opinion demonstrates that the Commission's conclusion that such a method is unworkable follows from a generalized view of the problem of producer rates rather than from the inability of the Commission to utilize the cost of service method in these Phillips cases.

Embarkation upon the area method preferred by the Commission does not necessitate judicial intervention, certainly not at this time; for judicial review must await a Commission order based upon that method. We should not seek to deter the Commission from pursuing such a method in future proceedings, or from using it in any proceedings already initiated along those lines. But it does not follow in my opinion that the Commission should be affirmed in failing to decide the present cases, though it may need to update the record. In the same breath as it were in which it describes the unworkability of the cost of service method the Commission itself accepts that pre-

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[1] 52 STAT. 822 (1938), 15 U.S.C. § 717c (1958).

[2] 52 STAT. 823 (1938), 15 U.S.C. § 717d (1958).

cise method in finding that no refunds are to be required in the section 4(e) proceedings, stating:

> While we have found that the rate base method is not an effective means of regulating the producers' prices, evidence in this proceeding was presented almost entirely upon the cost basis and, of course, there were no ceiling prices issued by us at the time of the hearing. There was some field price evidence intro- [fol. 431] duced, but if field prices could be employed in arriving at rates for Phillips, the evidence was incomplete and unrepresentative of Phillips' diverse sales. Therefore we shall proceed on the basis of the evidence adduced in this case to reach conclusions, as reasonable, intelligent and logical as possible even though we know and have herein stated the difficulties inherent in determining a cost of service for Phillips using the rate method. This is clearly a lawful way to determine rates for Phillips as illustrated by the *City of Detroit* case,[11] and under the present record is the only possible method, and therefore we shall make every effort to reach a result by this means.
>
> [11] *City of Detroit* v. *F.P.C.*, 230 F. 2d 810 (CADC), *certiorari* denied, 352 U.S. 829.

The Commission could as well have proceeded, with supplemental data, to decide the question of justness and reasonableness of the rates in the section 4(e) proceedings, and, also, to have determined under section 5(a) the just and reasonable rates to be thereafter observed and enforced.

This view is strongly fortified by the able decision of the Presiding Examiner. After an illuminating analysis of the voluminous record made on a cost of service basis he was able to propose definitive decisions. The record had been made with the cooperation of all parties, Phillips itself affirmatively acquiescing in the position that cost of service was the appropriate basis on which to proceed. Phillips' position, as the Examiner points out, was that its jurisdictional rates should be determined upon the basis of an overall cost of service.

It is one thing to say, as the Commission does, that the area method should hereafter be adopted, or even adopted in other cases which have not proceeded as far as those before us. It is quite another thing to say that the latter should not be decided under the standards of the Act because the area method was not used in preparing the record. Unless decided Phillips' challenged rates are left un- [fol. 432] determined under the standards of the Act since 1948, and apparently will continue to remain undetermined until some future day when new proceedings, now in an inchoate status with no end in sight, are concluded. Difficult and complicated as the tasks of the Commission admittedly are I cannot agree after reading the Examiner's decision or the Commission's findings that the congressional mandate of section 4(e), which requires that these matters shall be decided "as speedily as possible," is being complied with, or that the responsibilities of the Commission under the Act are discharged in the situation resulting from the termination order.

These cases need not be treated as if they were ventures initiated in search of an ideal method of regulating the rates of independent gas producers. Having in mind the history of these proceedings, and the primary congressional purpose of consumer protection, it seems to me that decisions on the present record, supplemented as may be found to be reasonably necessary, would be far more likely to approximate fulfillment of the purposes of the Act than are the termination order and the resulting situation.

The Commission says it has a discretion to terminate as well as to initiate; but once it has exercised its discretion to initiate and has pursued the matter to the extent we find here its discretion to terminate is not as broad as was its discretion to initiate. The former becomes limited by the conditions existing at the time of its exercise. *Minneapolis Gas Co.* v. *Federal Power Comm'n*, —— U.S. App. D.C. ——, 294 F.2d 212. Compare *Eastern Air Lines, Inc.* v. *Civil Aeronautics Board*, —— U.S. App. D.C. ——, 294 F.2d 235.

The Commission has actually found Phillips' cost of service on the basis of the record made and has arrived on the same record at a proper rate of return, stating

"this is clearly a lawful way to determine rates for Phil-[fol. 433] lips as illustrated by the *City of Detroit* case, . . . and under the present record is the only possible method . . ." In this manner the Commission has come so close to doing what it says it should not do as to demonstrate that it is able to do what it has failed to do.

The finding of the Commission in the section 4(e) proceedings that there could be no refunds because the cost of service exceeded the revenues on the basis of the data for the 1954 test year, I think does not justify the order terminating all but two of the section 4(e) proceedings, or the Commission's invitation to Phillips to move to terminate all others which are still pending. The absence of a decision on the issue of justness and reasonableness of rates has the effect of leaving all rates subsequent to 1954 untested under the standards of the Act. Substance is not achieved merely by finding whether or not refunds were due on the basis of the 1954 data. A finding in that regard should not be independent of a finding of the just and reasonable rates. The former should follow from the fact that the just and reasonable rates are not exceeded by those in effect.

The decision of these cases under the standards of the Act not only would not preclude the Commission from embarking upon the area method, but it also would not preclude the Commission from correcting or modifying the decision should the area proceeding show such correction or modification to be desirable; nor do I think a decision on the present record, supplemented as may be needed, would preclude the Commission, pending conclusion of an area proceeding, from establishing guides, formulated, however, with the aid of a decision in the present proceedings.

I agree with Judge Prettyman as to the prematurity of the request for action on two section 4(e) proceedings which have not been terminated.

[fol. 434] [File endorsement omitted]

IN UNITED STATES COURT OF APPEALS

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 16175

STATE OF WISCONSIN and PUBLIC SERVICE COMMISSION OF WISCONSIN, Petitioners,

v.

FEDERAL POWER COMMISSION, Respondent,
PHILLIPS PETROLEUM COMPANY, Intervenor.

No. 16177

LONG ISLAND LIGHTING COMPANY, et al., Petitioners,

v.

FEDERAL POWER COMMISSION, Respondent,
PHILLIPS PETROLEUM COMPANY, PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK, Intervenors.

No. 16180

PEOPLE OF THE STATE OF CALIFORNIA and PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, Petitioners,

v.

FEDERAL POWER COMMISSION, Respondent,
PHILLIPS PETROLEUM COMPANY, Intervenor.

On Petitions for Review of Order of the Federal Power Commission

Before: Prettyman, Fahy and Danaher, Circuit Judges.

JUDGMENT—November 30, 1961

These cases came on to be heard on the record from the Federal Power Commission, and were argued by counsel.

On Consideration Whereof, It is ordered and adjudged by this court that the order of the Federal Power Commission on review in these cases is affirmed.

Per Circuit Judge Prettyman.

Dated: November 30, 1961.

Separate dissenting opinion by Circuit Judge Fahy, with partial concurrence.

[fol. 439] Clerk's Certificate to foregoing transcript (omitted in printing).

[fol. 440]

SUPREME COURT OF THE UNITED STATES

No. 754, October Term, 1961

WISCONSIN, et al., Petitioners,

vs.

FEDERAL POWER COMMISSION, et al.

ORDER ALLOWING CERTIORARI—May 14, 1962

The petition herein for a writ of certiorari to the United States Court of Appeals for the District of Columbia Circuit is granted. The case is consolidated with Nos. 755 and 756 and a total of three hours is allowed for oral argument.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

Mr. Justice Frankfurter took no part in the consideration or decision of this application.

[fol. 441]

SUPREME COURT OF THE UNITED STATES

No. 755, October Term, 1961

CALIFORNIA, et al., Petitioners,

vs.

FEDERAL POWER COMMISSION, et al.

ORDER ALLOWING CERTIORARI—May 14, 1962

The petition herein for a writ of certiorari to the United States Court of Appeals for the District of Columbia Circuit is granted. The case is consolidated with Nos. 754 and 756 and a total of three hours is allowed for oral argument.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

Mr. Justice Frankfurter took no part in the consideration or decision of this application.

[fol. 442]

SUPREME COURT OF THE UNITED STATES

No. 756, October Term, 1961

LONG ISLAND LIGHTING CO., et al., Petitioners,

vs.

FEDERAL POWER COMMISSION, et al.

ORDER ALLOWING CERTIORARI—May 14, 1962

The petition herein for a writ of certiorari to the United States Court of Appeals for the District of Columbia Circuit is granted. The case is consolidated with Nos. 754 and 755 and a total of three hours is allowed for oral argument.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

Mr. Justice Frankfurter took no part in the consideration or decision of this application.

Office-Supreme Court, U.S.
FILED
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JOHN F. DAVIS, CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM 1961.

No. 754 72

STATE OF WISCONSIN and PUBLIC SERVICE COMMISSION OF WISCONSIN, and

PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK,
Petitioners,

v.

FEDERAL POWER COMMISSION,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT.

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Dated: February 27, 1962.

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IN THE

Supreme Court of the United States

OCTOBER TERM 1961.

No. .....

STATE OF WISCONSIN and PUBLIC SERVICE COMMISSION OF WISCONSIN, and

PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK,
Petitioners,

v.

FEDERAL POWER COMMISSION,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT.

Petitioners, State of Wisconsin and Public Service Commission of Wisconsin, and Public Service Commission of the State of New York, pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the District of Columbia Circuit, entered in the above-entitled case on November 30, 1961.

Opinions Below.

The opinion of the Court of Appeals (App. A, *infra*, pp. A1-A23) is not yet reported. The opinion and order of the Federal Power Commission (R. 251-342) are

reported at 24 F.P.C. 537, and the Commission's order denying rehearing (R. 395-404) is reported at 24 F.P.C. 1008. The decision of the presiding examiner (R. 35-217) is reported at 24 F.P.C. 590.

Jurisdiction.

The judgment of the Court of Appeals affirming the Commission's orders was entered on November 30, 1961 (App. B, *infra*, pp. B1-B2). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

Question Presented.

The question is whether the Federal Power Commission, for reasons of administrative convenience, may indefinitely defer fixing just and reasonable rates for natural gas producers' sales in accordance with proven and established procedures under Sections 4 and 5 of the Natural Gas Act because it has chosen to embark upon an entirely new, unformulated and judicially untested method of producer rate regulation, when such indefinite deferral will cause massive and irreparable injury to the consuming public.

Statute Involved.

The pertinent provisions of the Natural Gas Act, 52 Stat. 821, as amended, 15 U.S.C. 717-717w, are set out in Appendix E, *infra*.

Statement.

The original proceedings, 1948-54—The Phillips Petroleum Company is a large integrated oil company, which at all times pertinent here has been and is the largest producer-seller of natural gas, accounting for approximately 10% of the national total. In October 1948, Respondent instituted an investigation under Section 5(a) of the Natural Gas Act to determine whether Phillips was a natural gas company and if so whether its rates were unjust and unreasonable (R. 17-20), 7 F.P.C. 983. Following a full-scale field investigation and hearings, Respondent in August 1951 held that Phillips was not a natural gas company, 10 F.P.C. 246. On review, the Court of Appeals for the District of Columbia Circuit reversed, and entered a judgment directing respondent to "fix the rates at which [Phillips' interstate] * * * sales are made." *Wisconsin* v. *Federal Power Commission*, 205 F. 2d 706, 712 (D.C. Cir. 1953) (R. 405-6). In June 1954, this Court affirmed the mandate of the Court of Appeals. *Phillips Petroleum Company* v. *Wisconsin*, 347 U.S. 672.

The current proceedings, 1954-62—On receipt of the Court of Appeals' mandate, Respondent reinstated its investigation into the lawfulness of Phillips' rates under Section 5(a) of the Natural Gas Act, consolidating with the investigation twelve rate increases filed by Phillips under Section 4(e) of the Act (R. 21-23).

In addition to reopening the Phillips proceeding, the Commission instituted Section 5(a) investigations into the rates of 37 producers. Eleven of these investigations, pertaining to major independent producers, have been carried forward almost to completion (App. C, *infra*, p. C1); the eleven producers account for approximately one-third of all interstate sales of natural gas. Complete cost-of-service

presentations have been introduced by the Staff in each of these cases, and hearings have been concluded in all but one. Two have already been the subject of Examiners' decisions, and in five others all briefs have been filed.[1]

The remanded hearings—The hearings on remand commenced before one of Respondent's examiners in June 1956 and concluded, after 91 days of hearing, in December 1957. During this time the record rose to 27,000 pages, with an additional 2,000 pages of exhibits and 4,000 pages of miscellaneous pleadings and orders. At the commencement of the hearing all parties agreed that Phillips' rates should be determined on a cost-of-service basis (R. 60), and Phillips cooperated in making available exhaustive data covering all phases of its natural gas business, including cost-of-service data for test years 1954 and 1956 (R. 86).

The Examiner's decision—In April 1959, the Examiner issued a 342-page decision (R. 35-217; 24 F.P.C. 590); it incorporates detailed findings as to Phillips' rate base, costs, required rate of return, and all other relevant issues, and reaches the ultimate conclusion that Phillips' jurisdictional cost of service[2] for the 1954 test year was $57.3 million, equivalent to an average unit cost of 11.7¢ per Mcf (R. 211). The Examiner directed Phillips to design and file a schedule of rates which, when applied to sales being made in 1954, would recover this cost of service. He further provided that the rates for all sales instituted after 1954 should be adjusted to conform to the schedule of rates

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[1] As petitioners point out, *infra*, pp. 16, 24-25, the record in these cases would provide a feasible and lawful basis for determining the reasonableness of current producer rate levels during the period pending completion of the area rate proceedings contemplated in Respondent's order here under review (R. 266-7).

[2] As correctly noted by the court below, "cost-of-service in this context includes not only operating expenses, taxes, exploration allowances, and gas purchases but also a fair return upon the rate base."

thus derived (R. 214). Pursuant to this direction, Phillips prepared and filed a preliminary schedule of rates (R. 218-225), but inasmuch as the Commission dismissed the proceedings, a final schedule was never submitted. (See R. 226).

The Commission's Opinion 338—Following exceptions filed by interested parties (R. 253) and oral argument, the Commission issued its Opinion No. 338 on September 28, 1960 (R. 251-341). The first part of the opinion is devoted to an analysis of the feasibility of regulating independent natural gas producer rates through use of individual company costs and investment (R. 258-266). Consistent with Respondent's previously expressed distaste for producer regulation,[3] the opinion recites the purported difficulties and unsolved problems which, according to Respondent, were the inevitable result of employing a cost-investment rate base as a starting point in regulating natural gas producers. After complaining of the clogged condition of its dockets, Respondent concluded that it would be neither administratively nor economically sound to utilize individual producer costs to fix independent producer rates (R. 265).

While prospectively rejecting future reliance on individual producer costs, Respondent's opinion noted that cost-based regulation was "clearly a lawful way to determine rates for Phillips . . . and under the present record is the only possible method." (R. 269).

Finding that the "jurisdictional cost of service for . . . [1956] was not very different from 1954" (R. 272), Respondent adopted the 1954 test year employed by the Examiner and proceeded to find Phillips' jurisdictional

[3] FPC, 35th Annual Report (1955), 177;
FPC, 37th Annual Report (1957), 17-18, 25;
FPC, 38th Annual Report (1958), 16-17;
FPC, 39th Annual Report (1959), 12-13, 18-19;
FPC, 40th Annual Report (1960), 17.

cost of service to be $54.5 million[4] subject to adjustment for purchased gas costs, gathering taxes and royalties, or 11.1¢ per Mcf on jurisdictional sales of 491,178,953 Mcf (R. 404). Jurisdictional revenues for 1954 were $45.6 million, resulting in an $8.9 million deficit for that year; the 1954 revenues do not include, of course, additional revenues experienced in subsequent years from the Section 4(e) increases consolidated with the rate investigation, from other Section 4(e) increases, from additional sales volume, and from new sales at higher prices.

Expressly relying upon unidentified extra-record "knowledge . . . that costs and prices of gas in the field have greatly increased since that time," Respondent, after concluding that Phillips' rates were not excessive in 1954, inferred without record support that they were "probably" not excessive through 1958—by which date it recognized that "very substantial further rate increases were filed by Phillips" (R. 324-329). Since it had also concluded that "there is nothing in the record to show that these past rates . . . are unduly discriminatory or preferential" (R. 325), Respondent terminated all but two of the Section 4(e) proceedings[5] and discharged Phillips from further refund obligation, thereby approving existing[6] and increased rates during the 1957-1959 period, based solely on 1954 costs and revenues.

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[4] As revised in the order denying rehearing (R. 401).

[5] The rates called for by the rate schedules involved in Docket Nos. G-10883 and G-11217 are subject to revision on contractual grounds upon the decision of certain pending pipeline rate cases, and hence these dockets were held open on this limited issue (R. 326-28).

[6] Regularly since 1954, Respondent has authorized all producers, including Phillips, to undertake new sales at initial prices more than double the 1954 average price; its justification for not scrutinizing the justness of these prices was that they would eventually be reviewed in the Section 5(a) investigations, where they could be prospectively lowered.

With regard to the Section 5 investigation, involving Phillips' future rates, Respondent recognized that "the next step would ordinarily be to alter Phillips' rates . . . prospectively . . ." (R. 323). Notwithstanding the pendency of some 95 substantial rate increases filed by Phillips (R. 324, 329),[7] however, Respondent terminated without further action the general Section 5(a) rate investigation. This action was justified on two principal grounds: (1) that it would be "a result without reason or justice" to fix Phillips' 1960 rates upon data for an earlier test year (R. 325),[8] and (2) that "the interest of consumers and the exigencies of regulation will be better served in rate proceedings brought on an area basis rather than on an individual company basis" (R. 397).

Statement of General Policy No. 61-1—Concurrently with its opinion herein, Respondent issued a Statement of General Policy No. 61-1, 25 Fed. Reg. 9578, containing two lists of area prices, one for initial rates for issuing certificates under Section 7 and another for increased rates (under Section 4(e)) for gas sold under existing contracts, for use "as a guide to us [the Commission] and to interested parties in determining whether proposed initial rates should be certificated without price condition and whether proposed rate changes should be accepted or suspended" (R. 343). Respondent expressly represented, however, that the guides were tentative and did not propose to establish "just and reasonable" rate levels for Phillips or any other producer (R. 266, 346). The Policy Statement was issued without notice, hearing or record,

[7] As the opinion itself points out, the total annual impact of just five of these increases is approximately $11,000,000 (R. 324, n. 43).

[8] This point was abandoned by counsel for Respondent at the argument in the court below.

and has been amended several times since, also without notice, hearing or record.

Decision of the court below—On November 30, 1961, the Court of Appeals for the District of Columbia Circuit, Judge Fahy dissenting, sustained the Commission and affirmed its order.

At the outset of its opinion, the court recognized that it was confronting a problem of major importance, stating, "Some controversies concern major problems of general application. Others concern only a limited set of circumstances. The case at bar is of the former variety." (App. A, *infra*, p. A3.)

The court found that three time periods were involved. The first covered the "locked in" period, running from February 1955 through July 1959, during which certain of Phillips' rates were subject to refund under the twelve Section 4(e) dockets. The second covered the period of Phillips' "current rates", that is, rates being charged in 1959 and thereafter until such time as the Commission's proposed area rate making procedures are formulated and placed into effect. The third time period follows completion of the proposed area rate proceedings, at which time rates for the future would be established by reference to the new area standard.

Considering the first time period, the majority held that the Commission had properly allowed Phillips' rate increases to become effective for the 1955-1959 period solely on the basis of its determination of 1954 costs and revenues.[9]

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[9] As Petitioners point out, *infra*, p. 23, the majority seems to have overlooked the fact that the Commission had no record support for its implied finding that the 1955-1959 rate increases were "just and reasonable." See *Smith* v. *Illinois Bell Tel. Co.*, 282 U.S. 133 at 161-2 (1930).

After a brief discussion of the third period, involving Respondent's projected treatment of "future" rates in the proposed area proceedings,[10] the court then turned to the middle of the three time periods, that involving "current" rates. The court recognized that the "current" period could last as long as fourteen years and that Respondent is obligated to protect consumers during this period by some form of interim regulation. Although Respondent had proposed to defer regulation of existing rates indefinitely, the majority suggests that the Commission will be able to use its SGP61-1 rates during this period to test the reasonableness of existing rates as well as to test proposed initial rates or to decide whether to suspend and investigate rate increases.[11]

Since the SGP61-1 rates had been adopted without notice, hearing, record or specific findings, and appear to be based primarily on existing field prices (*infra*, pp. 15-16), the court, as a necessary support for its conclusions, held (1) that the Commission could lawfully base its determination of just and reasonable rates on field price data alone without reference to the financial requirements of the producers (App. A, *infra*, pp. A16-A18), and (2) that the SGP61-1 temporary rate levels were in fact "just and reasonable" rates which could be used for this purpose, subject

[10] Inasmuch as the Commission's plans for area proceedings are "now in an inchoate status" (App. A, *infra*, pp. A21-A22), any consideration of the validity of such a procedure would be premature at this time. See *infra*, p. 14.

[11] The court states (App. A, *infra*, p. A18) that "the new method [i. e., the SGP61-1 interim rates] will also apply in 5(a) proceedings to any existing rate found to be unjust or unreasonable." As we shall show, *infra*, p. 15, the court here misconceives the purpose of the SGP61-1 levels, which were not intended by the Commission to be used in determining just and reasonable rates in Section 5(a) proceedings, but solely to determine whether or not to suspend and investigate rate increases under Section 4 and to determine the lawfulness of initial rates in proceedings under Section 7 of the Natural Gas Act, 15 U.S.C. 717f.

to challenge in individual rate proceedings (App. A, *infra*, p. A17).

Finally, the court, after pointing out that "the Commission has found that present rates result in deficits to the company",[12] concluded that the Commission's order was valid and should be affirmed.

Judge Fahy dissented[13] (App. A, *infra*, pp. A20-A23). He pointed out that Respondent's opinion demonstrated the feasibility of deciding the Phillips' Sections 5(a) and 4(e) cases on the basis of the existing record, supplemented as necessary; that the majority should not have attempted to settle the validity of the area rate method since that question was not properly before it; that the result of the Commission's action would be to leave Phillips' rates unregulated for the indefinite future, which is entirely inconsistent with the mandate of the Natural Gas Act; that a Commission decision on the record, supplemented as necessary by more recent data, would be far more consistent with the mandate of the Act than the Commission's actual termination of the proceedings based on 1954 data; that the Commission could not dispose of the issue as to the justness and reasonableness of the present 1960-1961 rates on the basis of the 1954 data; that a decision in this case would not preclude the Commission from embarking on an area rate making program; and that the results of the Section 5(a) proceedings presently nearing completion before the Commission could provide assistance to the Commission in establishing guides of the SGP61-1 type, pending the completion of the area proceedings.

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[12] This is an inadvertent misstatement of the record, inasmuch as Respondent's finding was based on Phillips' 1954 costs as compared with its 1954 rates, and Respondent expressly refused to require Phillips to submit current cost and revenue figures relating to the "present" period of 1960-61. (R. 396-7).

[13] With partial concurrence on a point not raised by Petitioners herein.

Reasons for Granting the Writ.

The majority decision below emphasizes (App. A, *infra*, p. A3) that this is a case of major importance, involving one of the most significant Federal regulatory issues to come to this Court in a decade. Subsequent to this Court's *Phillips* decision in 1954, the major unresolved problem of Federal Power Commission regulation has been the fixing of just and reasonable producer rates. Since *Phillips*, the average field price of gas has risen over 60 percent and is continuing to rise rapidly; all of this increase is, of course, paid by the ultimate consumer. Because the FPC's rate-making powers, to the extent pertinent here, are predominantly prospective and cannot reach back to require disgorgement of present and past excesses, all delay in fixing just and reasonable producer rates works to the detriment of the consuming public.

The decision below would permit the Federal Power Commission, without good and sufficient reason, to defer resolution of the producer rate problem for an indefinite period, estimated at not less than four years and extending perhaps as much as fourteen years. The decision below will thus cause enormous and irreparable injury to ultimate consumers of natural gas for an indefinite future period.

Further, the decision below would permit a regulatory agency to achieve a prohibited abdication of jurisdiction by adopting a policy which amounts to an indefinite deferral of exercise of jurisdiction. Discretion an agency has; but not the discretion to repeal its statutory grant of power.

We submit, furthermore, that the decision below is squarely in conflict with earlier decisions of the same court of appeals and is inconsistent with other decisions of that and another court of appeals, as well as with two decisions of this Court.

1. Indefinite Deferral of Effective Regulation.

The purpose of the Natural Gas Act is, as this Court has frequently held, to protect the consumer from exploitation at the hands of the natural gas company. *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591, 610 (1944); *Sunray Mid-Continent Oil Co.* v. *FPC*, 364 U.S. 137, 147 (1960). To achieve this purpose, the Federal Power Commission has been endowed with substantial regulatory jurisdiction over the natural gas industry, and has, as a regulatory agency should, considerable discretion in the exercise of its jurisdiction. But both the scope and the exercise of the Commission's jurisdiction must be interpreted in light of the Commission's primary statutory purpose—consumer protection. *FPC* v. *Transcontinental Gas Pipe Line*, 365 U.S. 1 (1961) (FPC's broad interpretation of its jurisdiction upheld); cf. *Phillips Petroleum Company* v. *Wisconsin*, 347 U.S. 672 (1954) (FPC's narrow interpretation of its jurisdiction reversed). *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944) (FPC action upheld as within the allowable scope of agency discretion); cf. *Atlantic Refining Company* v. *Public Service Commission of New York*, 360 U.S. 378 (1959), and *City of Detroit* v. *FPC*, 230 F. 2d 810 (D.C. Cir. 1955), cert. den. 352 U.S. 829 (FPC action reversed notwithstanding agency's claim of discretion to select a regulatory method).

The vice of the Commission's decision is that it deprives the consumer of the "complete, permanent and effective bond of protection"[14] which the Natural Gas Act intended; specifically, the right to be free from excessive rates for natural gas.

Upon being told by this Court in 1954 that producers selling natural gas for resale in interstate commerce were subject to regulation under the Natural Gas Act, respond-

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[14] *Atlantic Refining Co.* v. *Public Service Commission of New York*, 360 U.S. 378, 388 (1959).

ent's responsibilities fell into two major categories. First, it was obliged to fix, as rapidly as possible, the just and reasonable rate for producer sales—a task then sixteen years overdue. Second, since it was evident that the ultimate fixing of producer rates would take some time, respondent was under an obligation to maintain control over price levels until it could, by completing its first task, determine whether adjustments were necessary. The two items were, of course, interrelated. The longer respondent took to fix just and reasonable rates, the more important interim price-protection measures became, *Atlantic Refining Company* v. *Public Service Commission of New York*, 360 U.S. 378; and the less effective respondent's efforts to stabilize prices during the period when just and reasonable rates were being determined, the more important speed in fixing rates became.

Unfortunately, respondent neither stabilized the price level pending ultimate conclusion of the rate proceedings—from 1954 to 1960, the average price of gas sold by producers to interstate pipelines advanced from 9.9¢ to 15.6¢ per Mcf[15]—nor did it move with speed in its rate-fixing proceedings. Respondent's more egregious failures to make any effort at stabilizing prices have twice been reversed by this Court and six times by courts of appeals,[16] and the imperceptible forward motion of respon-

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[15] The 1954 level of 9.9¢ represented an all-time high, and compares with a range of 4.5¢-6.5¢ between 1938 and 1950.

[16] *Atlantic Refining Co.* v. *Public Service Commission of New York*, 360 U.S. 378 (1959); *Public Service Commission of New York* v. *FPC*, 361 U.S. 195 (1959); *United Gas Improvement* v. *FPC*, 283 F.2d 817 (9th Cir. 1960), cert. denied 365 U.S. 879, 881; *Public Service Commission of New York* v. *FPC*, 287 F.2d 146 (D. C. Cir., 1960), cert. denied 365 U.S. 880, 882; *Public Service Commission of New York* v. *FPC*, 287 F.2d 143 (D. C. Cir., 1960); *United Gas Improvement* v. *FPC*, 287 F.2d 159 (10th Cir., 1961); *United Gas Improvement* v. *FPC*, 290 F.2d 133 (5th Cir., 1961), cert. denied, 368 U.S. 823; *United Gas Improvement* v. *FPC*, 290 F.2d 147 (5th Cir., 1961), cert. denied, 366 U.S. 965.

dent's rate proceedings have twice drawn comment from this Court.[17]

Nonetheless, by the fall of 1960, the Phillips rate proceeding *was* ready for decision, and the Section 5(a) rate proceedings of a half dozen other major producers were nearing conclusion. It was at this juncture that respondent decided to drop the individual-company cost-of-service method employed by all parties in all the pending cases and embark instead upon a new method (in essence a multi-company cost-of-service method). Assuming *arguendo* that the new method constitutes a desirable and legal way of fixing producer rates, the decision defers effective rate-fixing for another four years at least. And if the Commission has as broad discretion as the decision below suggests, when all the preliminary stages incident to the new method have been completed and the Commission is again on the brink of decision, it could presumably decide that a third method might be still better, and terminate the area proceedings without arriving at a definitive result.

The court below, of course, recognized that there is a "need for interim regulation." To meet this need, it asserted (App. A, *infra*, pp. A14, A18) that the Commission's temporary "area prices" (promulgated in its Statement of General Policy No. 61-1, hereafter SGP61-1) can and will be applied to existing and future rates under Section 5(a) so as to protect consumers against unjust and unreasonable average rate levels pending completion of the area proceedings. Thus, the court below apparently believed that Respondent intended in SGP61-1 to adopt (at least during the interim) a variation of the "fair field price" regulatory method for which Respondent has sought authorization so often and so fruitlessly from Congress.[18]

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[17] 360 U.S. 378, 389-90; 364 U.S. 137, 144-5.

[18] See fn. 3, *supra*.

This is a fundamental misconception, since SGP61-1 itself makes clear (R. 343) that the 61-1 rates are to be used *only* in conditioning initial prices under Section 7 of the Act and in suspending (but not testing) increased rates under Section 4(e)—not in setting just and reasonable rates under Section 5(a). This is confirmed by other Commission statements, most recently in Respondent's Opinion No. 350 issued over a month after the decision below, stating that "The area price levels, as set forth in the Policy Statement and its amendments, are 'for the purpose of guidance and initial action by the Commission,' and do not constitute determinations of just and reasonable prices."[19]

The court below not only misunderstood what the SGP levels were, equally important, it misunderstood how they were computed. Thus, the court states that the levels were based on Respondent's "own judgment and accumulated data" and "on the basis of the internal data in its files on all the operators in the several areas." While this suggests that the data on which the SGP levels are based include producer expense data, Appendix D demonstrates that the SGP61-1 prices in each case are merely the highest previously permanently certificated and wholly unregulated price in each area as of September 1960 when SGP61-1 was issued. And as one leading authority has commented, "the area prices . . . come close to approximately current

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[19] *Panhandle Eastern Pipeline Co.*, Opinion No. 350, January 15, 1962, 27 F.P.C. ; Mimeo., p. 9. Since the SGP levels were issued without hearings, record or findings of any kind, and since they appear to be based largely, if not exclusively, on unregulated field prices, it is hardly likely that Respondent could or would attempt to employ them to reduce existing or future rates to "just and reasonable" levels. *Ohio-Bell Telephone Co.* v. *Public Utilities Comm'n of Ohio*, 301 U.S. 292; *Colorado-Wyoming Gas Co.* v. *F.P.C.*, 324 U.S. 626, 633-635; *I.C.C.* v. *J-T Transport Co.*, 368 U.S. 81. This is no doubt why Respondent has repeatedly disclaimed any intention of using the 61-1 rate levels other than as a guide to its discretion in conditioning initial prices or in suspending and investigating increased rates.

maximum prices, which have more than doubled in the past five years.'"[20]

There are, of course, many areas in which the Commission's files, internal or otherwise, would furnish data which could be used in appropriate cases—the cost of transporting an Mcf of gas 100 miles through 24-inch pipe, for example. But the recordation in the Commission's files of prices which have been or are being paid does not validate as a method of price regulation the otherwise invalid "fair field price" doctrine. See further, *infra*, pp. 17-20.

We noted above that although area prices are ultimately intended to reflect industry-wide cost experience, the SGP levels reflect only current prices being paid. As Judge Fahy, dissenting below, pointed out, if the Commission were to fix rates in the Phillips and related rate investigations on the basis of the individual-company cost experience in the respective records, supplemented as necessary, it could accumulate the very type of cost-experience data necessary to establish price guides which *would* reflect just and reasonable prices. Thus, completion of the individual company cases, far from impeding the area price venture, would move it forward.

2. Abdication of Jurisdiction.

In its original 1951 decision in this proceeding, 10 F.P.C. 246, respondent held that it lacked power to regulate sales made by producers for resale in interstate commerce. As noted, that holding was reversed as an error of law by the Court of Appeals, 205 F.2d 706 (D.C. Cir. 1953) and by this Court, 347 U.S. 672 (1954). Thereafter, Respondent repeatedly asked Congress to amend the Natural Gas Act to exempt producers or to relax producer regulation.[21]

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[20] Landis, *Report on Regulatory Agencies to the President-Elect*, p. 55 (1960).

[21] See fn. 3, *supra*.

Respondent's 1960 opinion, affirmed by the decision below, would achieve a substantial portion of the abnegation of power disapproved by this Court and subsequently refused by Congress. Section 4(a) provides "All rates and charges made, demanded, or received by any natural gas company for ... the ... sale of natural gas subject to the jurisdiction of the Commission, ... shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful," and Section 5(a) requires that "Whenever the Commission ... shall find that any rate ... charged ... by any natural-gas company ... is unjust [or] unreasonable, ... the Commission shall determine the just and reasonable rate ... to be thereafter observed and in force, and shall fix the same by order."

In deferring producer regulation under Sections 4 and 5(a) for an indefinite period, the Commission has abdicated its basic regulatory functions under the Natural Gas Act. Its discretion to select a regulatory method does not permit it to abdicate its total regulatory responsibilities for a substantial period. The freedom from regulatory responsibility which the Respondent could not achieve as a matter of law the first time around, it should not be permitted to achieve as a matter of discretion nine years later in the same proceeding. The mandate of the Natural Gas Act to protect consumers is so strong that, in a period of rapidly rising field prices, Respondent has no discretion to put off its regulation until another day.

This generation of consumers, as well as the next, is entitled to protection.

3. Conflict With Other Decisions.

a. Consideration by this Court is necessary on the independent ground that the holding below conflicts squarely

with *City of Detroit* v. *F.P.C.*, 230 F.2d 810 (D.C. Cir. 1955), *cert. denied*, 352 U.S. 829; and *Mississippi River Fuel Corp.* v. *F.P.C.*, 252 F.2d 619 (D.C. Cir. 1957), *cert. denied*, 355 U.S. 904; and conflicts in substance with *Episcopal Theological Seminary* v. *F.P.C.*, 269 F.2d 228 (D.C. Cir. 1959), *cert. denied*, 361 U.S. 895; *Bel Oil Co.* v. *F.P.C.*, 255 F.2d 548 (5th Cir. 1958), *cert. denied*, 358 U.S. 804; *Forest Oil Co.* v. *F.P.C.*, 263 F.2d 622 (5th Cir. 1959); and *United Gas Improvement Co.* v. *F.P.C.*, 290 F.2d 133 (5th Cir. 1961), *cert. denied*, 368 U.S. 823.

The majority appears to hold that Respondent may rely upon "fair field prices" (i.e., unregulated prices set by existing market forces) in determining "just and reasonable" rates, without consideration of the producers' financial requirements (App. A, *infra*, p. A17). The court was presumably driven to this conclusion because it recognized that the interim area rates were based largely on unregulated field prices, and it could not hold that these rates are just and reasonable without also holding that Respondent need not consider producer costs or financial requirements even as a starting or comparison point in producer regulation.

The District of Columbia Circuit in *City of Detroit*, *supra*, 230 F.2d at 815-819, has held that the Commission could not, in determining just and reasonable rates for a pipeline which produced its own gas, allow the pipeline the fair field price (i.e., the going market price) for its gas without at least considering the pipeline's production costs as a check on whether fair field price would be excessive or exorbitant under the standards of the Act. This holding was subsequently applied to producer rates paid by an interstate pipeline company and claimed as a cost of service in *Mississippi River Fuel*, *supra*, 252 F.2d at 623 (reaffirmed,

Willmut Gas & Oil Co. v. F.P.C., F.2d (No. 16,245, D.C. Cir. 1962)).

The decision below conflicts squarely with these decisions in its holding that Respondent can set just and reasonable producer rates based solely on (App. A, *infra*, p. A16):

> "• • • the fair prices for the product as measured by the open competitive market for the product, evaluated by Commission expertise and data on the whole of the market operation."

In its holding on fair field price, the decision below also conflicts with the following decisions[22] involving Commission review of independent producer rates under Section 4(e) of the Natural Gas Act:

Bel Oil, supra, (255 F. 2d at 548):

> "• • • We do not hold that evidence of field price is irrelevant. We do hold that evidence of unregulated prices in the field is not sufficient to warrant a finding by the Commission that a price comparable to them is just and reasonable within the intendment of the Natural Gas Act. Neither is evidence of the field price when coupled with the opinion of experts that the price must be high enough to provide an incentive for exploration and development of new sources of supply."

(This holding is expressly reaffirmed in *Forest Oil Co. v. F.P.C.*, 263 F. 2d 622 (5th Cir. 1959); and *United Gas Improvement Co. v. F.P.C.*, 290 F. 2d 133, 135 (5th Cir. 1961)).

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[22] These decisions recognize, as did *City of Detroit, supra*, that the Commission is not *required* to employ a cost of service-rate base method of setting producer rates, but hold that "fair field price", alone, without consideration of financial requirements, does not meet the standards of the Act.

Episcopal Theological Seminary v. *F.P.C.*, 269 F. 2d 228, 236 (D.C. Cir. 1959), by Reed, Associate Justice (emphasis added):

> "What the Commission has done is to say that petitioners must make a showing as to its operations. It seems to us reasonable to make such a requirement. The primary aim of the Natural Gas Act is 'to protect consumers against exploitation at the hands of natural gas companies.' One aid to such an aim is to weigh the needs of the gas companies by an examination of its costs and profits. What better test could there be as to the reasonableness of existing or proposed rates to a company than a careful analysis of the evidence as to its recent earnings? *That is one of the elements of any rate-testing method.* [Footnotes omitted.]

See also *Public Service Comm'n of New York* v. *F.P.C.*, 287 F. 2d 146, 149 (D.C. Cir. 1960), cert. denied, 365 U. S. 880, 882.

The issue raised by this conflict is of continuing importance, and should be resolved by this Court. The Natural Gas Act by definition constitutes a legislative finding that competition alone cannot be relied upon to insure reasonable rates in the natural gas industry, *United Gas Improvement Co.* v. *F.P.C.*, 290 F. 2d 133, 135 (5th Cir. 1961); and we have noted earlier (*supra*, p. 16) that Congress has repeatedly refused to amend the Act to adopt a "fair field price" standard. The majority, in its statement quoted, *supra*, p. 19, does not explain how Respondent would be able to "evaluate" open market prices in the absence of any evidence of producer financial requirement; and it seems obvious that Respondent would have to approve uncritically as just and reasonable whatever the predominant field price level is at any time.

b. In holding that Respondent may decline to fix just and reasonable producer rates for yet another four years or more, the decision below is inconsistent with this Court's decision in *Phillips Petroleum Company* v. *Wisconsin*, 347 U. S. 672 (1954). See *supra*, pp. 12-13. While Respondent is entitled to a reasonable time within which to comply with this Court's mandate in Phillips, we would point out that almost eight years have elapsed since this Court directed Respondent to fix just and reasonable rates for *Phillips;* that Respondent has yet to fix such rates; and that the decision below would permit Respondent to defer indefinitely its obligation to fix rates for Phillips.

c. In holding that Respondent has no obligation to proceed with due diligence in the promulgation of interim relief pending ultimate determination of the producer rate problem, the decision below is inconsistent with this Court's decision in *Atlantic Refining Company* v. *Public Service Commission of New York*, 360 U. S. 378 (1959), a case which bears striking parallels to the instant proceeding.

In *Atlantic Refining*, the Federal Power Commission sought to defer action on a proposed high price for a new producer sale from the certificate proceedings, where the matter was ripe for interim action, to a subsequent rate investigation under Section 5; the Commission defended such postponement on the ground that the Section 5 proceeding would afford a more appropriate forum for the disposition of a rate issue. This Court disagreed. Finding that "the overriding intent of the Congress to give full protective coverage to the consumer as to price" would be defeated if potentially excessive prices were permitted to remain effective during the extensive time period

necessary to conclude a Section 5 proceeding, this Court held that the Commission was obligated to give careful scrutiny to the rate proposals in the certificate case. The Court stated:

> "The Act was so framed as to afford consumers a complete, permanent and effective bond of protection from excessive rates and charges . . . .
>
> "In view of this framework in which the Commission is authorized and directed to act, the initial certificating of a proposal under Section 7(e) of the Act as being required by the public convenience and necessity becomes crucial. This is true because the delay incident to determination in Section 5 proceedings through which initial certificated rates are reviewable appears nigh interminable. Although *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672, was decided in 1954, cases instituted under Section 5 are still in the investigation stage. This long delay, without the protection of refund, as is possible in a §4 proceeding, would provide a windfall for the natural gas company with a consequent squall for the consumers. This the Congress did not intend." 360 U.S. at 388-390.

Thus the specific holding in *Atlantic Refining* was that the Commission may not defer action on a rate problem until a Section 5 proceeding but must act on that problem when first presented in a Section 7 certificate proceeding. The *lesson* of *Atlantic Refining*, however, is that where the Commission has the choice of following two regulatory routes, one of which can be pursued promptly and the other of which will take many years for conclusion, it must follow the faster where the consumer will be injured by delay. In *Atlantic Refining*, action in the Section 7 proceeding afforded much prompter relief than action at the conclusion of a "nigh interminable" Section 5 proceeding; here,

action in the already completed Section 5 proceeding would afford much prompter relief than action at the conclusion of a not-yet-started area rate proceeding.

4. Impact on Consumer.

The impact of the decision below on the consuming public is enormous.

a. Between Respondent's 1951 determination that it lacked jurisdiction and its 1960 determination whereby it did not effectively exercise jurisdiction, the average price of gas more than doubled, from 7.3 cents per Mcf to 15.6 cents per Mcf. In terms of impact this means that in 1960 ultimate consumers of natural gas paid producers approximately $1,000,000,000 more than they would have had the 1951 field prices continued in effect; of this total, over 60 percent was paid by interstate consumers.

The recent rapid rise of producer prices — in which Phillips has shared—makes immediate relief essential. For example, between 1954 and 1960 Phillips' average unit revenues increased from 8.9 cents per Mcf to 14.3 cents per Mcf; the only evidence in this record of cost trends indicates that Phillips' unit costs *decreased* from 1954 to 1956.[22a]

Although the court below held that consumers had "no tenable grounds for complaint" of Phillips' present rates because the Commission "has found, after elaborate consideration, that *present* rates result in deficits to the company," the Commission in fact made no such finding. Rather, it found that Phillips' *1954* rates resulted in deficits to the Company in 1954. But since 1954, Phillips' sales have increased 30 percent, its average unit revenues have increased 60 percent, and its total jurisdictional revenues

[22a] As determined by Phillips on a consistent basis in Exhibits 282 and 303. See R. 86-88.

have more than doubled.[23] It is Petitioners' contention that under the cost-finding methods used by Respondent in this proceeding, Phillips' *present* rates are almost certainly excessive, and that a supplemental hearing, to compare Phillips' present revenues with its present costs, should be held.[24]

As Judge Fahy makes clear in his dissent below, the only presently available way of insuring that consumers will not pay exorbitant rates during the coming eight to ten years is for Respondent to utilize the records in the almost-completed thirteen major producer rate cases (including Phillips) to appraise the justness and reasonableness of existing sharply increased rate levels. It is entirely feasible for Respondent to do this, since the proceedings are virtually completed, and as the dissent points out (App. A, *infra*, p. A22): "The Commission has come so close to doing what it says it should not do as to demonstrate that it is able to do what it has failed to do."[25]

The majority below suggests that decision of these cases under Section 5(a) will offer no greater protection than that which *could* come out of the area rate proceedings, provided they are successfully completed.[26] Needless to

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[23] 1954 data from FPC Opinion 338; 1960 data from FPC staff report on 1960 producer sales, issued October 1961.

[24] Since the Phillips cost-finding methods have been determined, this would require only submittal of current cost data from Phillips' books. From the administrative standpoint, the relative ease with which this could be accomplished is demonstrated by the "Phillips-type" cost-of-service presentations made by the FPC Staff and other parties in each of the related rate investigations following this issuance of Respondent's Opinion 338 (Appendix C, *infra*).

[25] Hearings have been completed in all but one of the thirteen cases, and the final briefs have been submitted in all but five.

[26] "The new method will also apply in 5(a) proceedings to any existing rate found to be unjust or unreasonable. Refunds cannot be ordered in the latter cases and so consumers bear the disputed rates during the period of the inquiry. But this same situation obtains in the present process of regulation; the application of the new criteria makes no change in this procedural aspect." (App. A, *infra*, p. A18).

say, this overlooks the crucial fact that the existing producer cases admittedly could be decided in a relatively short time: the terminal dates of the area proceedings are speculative, but in any event, many years in the future.

Decision of the thirteen pending cases would offer substantial relief to the consumer in two ways. Appendix C, *infra*, demonstrates that this case alone involves rates governing nearing one-tenth of the natural gas sales subject to the Commission's jurisdiction, and that over 30% of jurisdictional sales by volumes and by revenue is the subject of current producer rate cases in which hearings have been concluded.[27] Thus, the Commission has the power directly within its grasp to provide substantial relief for the nation's rate payers simply by acting on the cases now before it.

Further, past experience indicates that rates set in these cases would provide a strong stimulus for settlement of other pending cases, and adjustment of producer rates generally to reasonable levels during the interim period pending completion of the area proceedings.[27]

b. The upward movement of producer prices has, of course, been the primary cause of rate increase filings by the pipeline purchasers,[28] leading to what the Commission has told this Court is "a serious backlog of cases".[29] In *F.P.C.* v. *Tennessee Gas Transmission*, this term No. 591, certiorari granted, respondent noted, "Pipeline rate increases have become more and more frequent in recent years." (Petition for certiorari, p. 19). In the *Tennessee*

[27] FPC Staff report on 1960 producer sales, issued October 1961.

[28] FPC Annual Reports, 1957, p. 82, 1958, p. 73; 1959, p. 79; 1960, p. 75.

[29] FPC petition for certiorari, *FPC* v. *Tennessee Gas Transmission*, this term No. 591, p. 20.

Gas case, which is fairly typical, the pipeline has since 1954 filed four increases which amount to almost $80,000,000 on an annual basis. Of this total, $56,000,000, or over 70 percent, is attributable to the rise in the pipeline's cost of purchased gas—the proper determination of which is the very problem here involved.[30] The problem of pipeline rate backlogs is a serious one, and the aspect of that problem raised by the *Tennessee* case—prompt disposition of specific issues to permit immediate partial refunds—is of real importance. But the *primary* cause of the pipeline rate problem is continued postponement of producer rate regulation—the issue presented here. *A fortiori* this case warrants certiorari.

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[30] The issue in the pending *Tennessee* appeal is whether the Federal Power Commission has power, in the circumstances, to trim Tennessee's rates by $11,000,000 annually to reflect a rate of return finding adverse to the pipeline. In dollar impact on the Tennessee system, the cost of purchased gas issue bulks five times as large as the issue involved in the pending *Tennessee* appeal.

Conclusion.

For the foregoing reasons, it is respectfully submitted that this petition for a writ of certiorari should be granted.

Dated, February 27, 1962.

Respectfully submitted,

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APPENDIX A.

Opinion of Court of Appeals.

UNITED STATES COURT OF APPEALS

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 16175

STATE OF WISCONSIN and PUBLIC SERVICE COMMISSION OF WISCONSIN,

Petitioners,

v.

FEDERAL POWER COMMISSION,

Respondent,

PHILLIPS PETROLEUM COMPANY,

Intervenor.

No. 16177

LONG ISLAND LIGHTING COMPANY, *et al.*,

Petitioners,

v.

FEDERAL POWER COMMISSION,

Respondent,

PHILLIPS PETROLEUM COMPANY,
PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK,

Intervenors.

No. 16180

PEOPLE OF THE STATE OF CALIFORNIA and PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA,

Petitioners,

v.

FEDERAL POWER COMMISSION,

Respondent,

PHILLIPS PETROLEUM COMPANY,

Intervenor.

ON PETITIONS FOR REVIEW OF ORDER OF THE FEDERAL POWER COMMISSION.

Decided November 30, 1961

Mr. WILLIAM E. TORKELSON for petitioners in No. 16175.

Mr. J. DAVID MANN, JR., with whom Messrs. JOHN E. HOLTZINGER, JR., WILLIAM W. ROSS, and DAVID K. KADANE were on the brief, for petitioners in No. 16177.

Mr. WILLIAM M. BENNETT for petitioners in No. 16180.

Mr. ARTHUR H. FRIBOURG, Attorney, Federal Power Commission, with whom Mr. JOHN C. MASON, General Counsel, Federal Power Commission, at the time the brief was filed, and now Deputy General Counsel, and Mr. HOWARD E. WAHRENBROCK, Solicitor, Federal Power Commission, were on the brief, for respondent.

Mr. KENNETH HEADY, of the bar of the Supreme Court of Oklahoma, *pro hac vice*, by special leave of court, with whom Messrs. CHARLES E. McGEE and LAMBERT McALLISTER were on the brief, for intervenor Phillips Petroleum Company.

Messrs. Kent H. Brown and George H. Kenny and Mrs. Barbara M. Sucnow were on the brief for intervenor Public Service Commission of the State of New York in No. 16177.

Before Prettyman, Fahy and Danaher, Circuit Judges.

Prettyman, Circuit Judge: Some controversies concern major problems of general application. Others concern only a limited set of circumstances. The case at bar is of the former variety. The questions are posed by complicated procedural difficulties. They concern the procedures of the Federal Power Commission in dealing with the rates of natural gas producers.

The Phillips Petroleum Company is a producer of natural gas. It procures gas from several widely separated and widely differing areas. It explores for, develops, produces, purchases, gathers and processes gas and oil. It sells gas to pipeline companies[1] under contracts negotiated by it and these customers. The contracts differ in such terms as delivery conditions, water content, hydrocarbon content, place of delivery, pressure, and price.

Two sections of the Natural Gas Act[2] are involved. One (Section 4(e)) provides in essence, as to sales subjected to regulation by the Commission, that when a rate or an increased rate is filed the Commission may suspend it for five months, meantime setting it for hearing. When such a rate goes into effect after the period of suspension (the Commission not having concluded its consideration), the funds derived from the newly-filed rates may be impounded and, in so far as the Commission fails to approve them, may be refunded. The burden of proving in such a proceeding that an increased rate is "just and reasonable" rests upon the company. The other section of the statute (5(a)) provides in essence that either upon a complaint or upon its own motion the Commission may inquire into an existing rate. If that rate be found unlawful the Commission must

[1] It also sells oil, products condensed from gas, and other petroleum products and chemicals. It sells natural gas in several conditions. It sells to customers other than pipelines as well.

[2] 52 Stat. 821 (1938), as amended, 15 U.S.C. §§ 717-717w.

determine what shall thereafter be decreed a just and reasonable rate. Its decision becomes effective from its date. No refund is involved.

In October, 1948, the Commission instituted a proceeding under Section 5(a), the latter of the above sections, concerning Phillips's rates. In that proceeding it decided it had no jurisdiction over the rates of producers of natural gas. This court reversed the Commission,[3] and the Supreme Court affirmed our decision.[4] The Commission reinstated its 5(a) proceeding.

Meantime and thereafter Phillips filed increased rates in respect to many of its contracts. The Commission suspended them and set them for hearing, under Section 4(e) of the statute, the first of the two sections above discussed. Many purchasers, many contracts, many rate schedules, and many filings were involved. Thus many 4(e) proceedings, under different docket numbers, were instituted. As time went on, Phillips filed further proposed increases in some of these same rates. In such event the earlier proposed rate would, if approved, cover a limited period, *i.e.*, until the succeeding increase in that same contract rate was filed. A period thus limited is called a "locked-in period" in the jargon of the industry. These later increases were also suspended by the Commission. Thus many proceedings under Section 4(e) involving rates of Phillips became pending.

The Commission consolidated the 5(a) proceeding and twelve of the 4(e) proceedings for hearing. These twelve 4(e) proceedings involved an aggregate of about five and a half million dollars in proposed increased rates. The proposed rates ranged from 5½ cents per Mcf to 13½ cents per Mcf. The proceeding was long, detailed, and resulted in a voluminous record of testimony and exhibits. The Examiner rendered a long (174 printed pages), careful and complete initial decision. He approached the

[3] *State of Wisconsin* v. *Federal Power Comm'n*, 92 U.S. App. D.C. 284, 205 F.2d 706 (1953).

[4] *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672 (1954).

problem from the standpoint of cost-of-service[5] and rate base. Many perplexing problems were presented. He examined them all and decided them. Among them were different approaches to cost-of-service, the allocation of production costs, the allocation of exploration costs, the problem of natural gas liquids, the rate base, adjustment to the test year, the computation of the income tax component, the proper rate of return, working capital, allocations between jurisdictional and non-jurisdictional sales, field prices, a discussion of system-wide as compared with area rates. Upon all these the Examiner made detailed findings and conclusions, displaying commendable patience and grasp of the subject matter. He adopted a system-wide approach and found that Phillips's total jurisdictional cost of service, properly computed, was $57,280,218 for the test year,[6] or an average unit cost of 11.662 cents per Mcf. He recommended that Phillips be ordered to calculate a maximum rate for gas with certain described qualities at such level that, when applied to the sales volume for all jurisdictional contracts, adjusted for approved delivery condition differentials, would produce revenues roughly equal to the system-wide cost of service. He recommended that Phillips be ordered to file, with full explanations, a list of rates so calculated. These calculated rates would be subject to approval by the Commission. He recommended that the rates thus calculated and approved be applied in both the 4(e) and the 5(a) proceedings, *i.e.*, to both suspended and future rates.

The Commission reversed the Examiner. Its decision and findings were also extended and exhaustive (82 printed pages, plus exhibits). One Commissioner dissented in respect to the computation of the cost of service; otherwise he concurred. Basically, the Commission concluded "beyond any doubt, that the traditional original cost,

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[5] Cost-of-service in this context includes not only operating expenses, taxes, exploration allowances, and gas purchases but also a fair return on the rate base.

[6] Compared with 92.3 million dollars claimed by Phillips.

prudent investment rate base method of regulating utilities is not a sensible, or even a workable method of fixing the rates of independent producers of natural gas." It pointed out critical differences between pipeline operations and producer operations, quoting from opinions by Mr. Justice Harlan and Mr. Justice Jackson, and saying that in regulating producers it is faced with problems entirely different from those of an ordinary public utility. It pointed out that simply to allow producers a return on investment would penalize the efficient or fortunate and reward the inefficient or unfortunate. Only where a producer purchases a fully developed acreage at a fair price does his investment have a real relationship to his return. The producer who first takes the risk in an area and proves it productive pays less for his rights than those who come later. But he must invest his funds before he knows whether he will have anything to sell or not. Mr. Justice Jackson once wrote that "there is little more relation between the investment and the result than in a game of poker."

The Commission pointed out that a producer of natural gas also produces oil, the price of which is unregulated, makes sales (intrastate, etc.) not subject to Commission jurisdiction, and sells products also excluded. Thus "extremely difficult" problems of allocating costs are involved. It commented that none of the experts proposed allocations acceptable to other experts. "Ridiculous results will be reached among the great number of producers and owners of interests if costs should be the only basis for regulation." It referred to the fact that much of Phillips's gas is purchased from thousands of independent producers whose rates are under percentage-type casinghead contracts, dependent on Phillips's rates. The interests of the many royalty owners must also be considered. Another problem is the administrative burden of full cost rate cases for each of thousands of independent producers. Adherence to cost rate-base methods results in necessity for a full-scale company-wide cost study to determine the proper price in any one contract. At the time of this

Commission decision 3372 independent producers had rates on file. Five hundred seventy producers were involved in 3278 proposed rate increases under suspension and awaiting hearing. Of eleven rate increase cases in which full hearings had been had and decisions rendered, ten showed the increases justified. A special problem prevented decision in the other. In the three 5(a) cases theretofore completed, the producers' prices were found justified. Rigid adherence to the rate-base method would in many cases price the producers' gas out of the market. "From the foregoing, it follows that effective regulation of the price of natural gas must be on some more manageable plan than the rate base method. Thus it is clear that the better method would be to establish fair prices for the gas itself and not for each individual producer."

Simultaneously with the foregoing opinion the Commission promulgated a "policy statement" setting forth rate guidance schedules for various producing areas. These schedules consisted of two rates prescribed for each of twenty-three producing areas throughout the country (except for two areas, for which only one rate was given). One rate was for initial service, *i.e.*, new contracts, in the area. The other was for increases in rates, *i.e.*, proposals for increases in existing contracts, in the area. For example, in the first area listed (Texas District No. 1) an initial service rate of 15.0 cents per Mcf was given and an increased rate level of 14.0 cents per Mcf. The Commission described its preparation of these schedules thus:

> "In arriving at the price levels for the various areas set forth in the appendix to this statement, we have considered all of the relevant facts available to us. Such consideration included cost information from all decided and pending cases, existing and historical price structures, volumes of production, trends in production, price trends in the various areas over a number of years, trends in exploration and development, trends in demands, and the available markets for the gas. Of necessity, we have not

> set forth the adjustments to these prices which must be made to take into account every possible provision of every contract which may affect the actual price, such as Btu adjustments, conditions of delivery, etc. The relevance of such adjustments to the basic contract price and the appropriate established price standard must be considered as each filing is made."

The proposed use of this list was described by the Commission as follows:

> "* * * These standards will serve as a guide to us and to interested parties in determining whether proposed initial rates should be certificated without a price condition and whether proposed rate changes should be accepted or suspended.
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> * * * * * *
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> "These price levels, as announced by Appendix A attached to this statement, are for the purpose of guidance and initial action by the Commission and their use will not deprive any party of substantive rights or fix the ultimate justness and reasonableness of any rate level."[7]

In its opinion the Commission said further: "This schedule of prices is only for guidance and does not constitute any determination of just and reasonable rates and will not foreclose any person from justifying a particular rate in any area." The schedule is of maximum acceptable rates for gas from a given area, as opposed to rates established for each rate filing by each producer after a full cost-rate base consideration of each rate so filed.

The Commission disposed of the consolidated cases before it in three parts. The first part consisted of the superseded rates of the prior periods ("locked-in" periods). The second consisted of the presently current rates and

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[7] Statement of General Policy No. 61-1, Sept. 28, 1960, 25 Fed. Reg. 9578 (Oct. 5, 1960).

those to be in effect during the interim period from now until the newly proposed area-rate system is completely designed and put into effect. The third part consisted of rates for the future after the completion and inauguration of the area-rate system.

Before we consider these several dispositions in detail we must understand the problem with which the Commission was dealing. The rates proposed to be increased in these 4(e) proceedings are not the rates of utilities in the traditional sense, such as pipelines. The rates here involved are the charges made by companies which buy or produce a product, process it to suit the requirements of a customer, and sell it to that customer under a contract. The product is procured from many different places, from Texas to West Virginia, from Louisiana to Wyoming. In its raw state it is of many different contents. Different customers require different terms as to the physical qualities of the delivered article, points and terms of delivery, and other factors. Hundreds of producers, hundreds of contracts, and thousands of rate filings are involved.

When we use the terms "cost of service" or "rate base" in this context, we must be careful of the meaning we intend. There is a system-wide cost of service. This would be, as the words indicate, a computation for the entire Phillips system. But even so it would not be a computation for all Phillips operations, because the Company has many operations, such as those in petro-chemical fields, and sales of all sorts of petroleum products, and many sales not subject to federal regulation under present statutes. In fact the Company's gross income from sales of natural gas in 1955 was less than six per cent of its total gross income. So even a system-wide computation of cost of service for sales of natural gas subject to Commission regulation requires monumental allocations of many costs, such as exploration costs, taxes, administration expenses, purchases, extraction costs, sales of residue gas and liquids, and so on. Nevertheless such a computation was made. The Examiner and also the

Commission determined and used a system-wide cost of service. As found by the Commission the system-wide cost of service for Phillips's sales of natural gas subject to Commission jurisdiction in the test year 1954 was $55,548,054, or 11.309 cents per Mcf. But even the figure thus carefully computed was subject to adjustment for purchased gas costs, gathering taxes, and royalties. The same observations apply to the rate base on a system-wide basis. One was determined by the Commission.

Then, theoretically at least, there is a cost of service for each contract, if not for each rate, and so for each 4(e) proceeding. But nobody, so far as we are advised, contends that any such computations could be made with any meaningful results by any known method. The results of any such effort would be pure guesswork, involving a vast multiplication of the arbitrary allocations which would have to be made.

The Examiner did not attempt to make any cost-of-service determination on individual contract, rate, or case basis. He determined a system-wide cost of service, which gave him a nationwide average unit cost of 11.662 cents per Mcf. He then proposed that "[b]ased on the system-wide cost of service herein approved, as set forth in Appendix Table 12 hereof, Phillips shall calculate the 'maximum rate for 1,000-pound, sweet, dehydrated, and gathered gas,' at such level that its application to the sales volumes delivered in 1954 under each and every one of the 1954 jurisdictional contracts, as adjusted for the approved delivery condition rate differentials, will produce total revenues roughly equal to such system-wide cost of service." He proposed further that "Phillips shall file with the Commission a statement of such 'maximum rate,' including a clear and detailed explanation as to the manner in which it was calculated, together with a list of *calculated rates* for all of its jurisdictional rate schedules then in effect." The Commission, as we have said, reversed the Examiner, treating the case, in effect, in three parts.

1. As to the first part of the problem, the 4(e) proceedings, dealing with suspended proposals now superseded, the Commission made system-wide conclusions as to jurisdictional sales and applied them to these cases. It found $45,568,291 of revenues against $55,548,054[8] cost of service. This showed a system-wide deficit of some $9,000,000 on jurisdictional sales of natural gas. The Commission noted that no evidence had been presented to show that the different rates in these different 4(e) proceedings were unduly discriminatory or preferential, which notation, translated, means that any adjustment in these rates should be correspondingly proportionate in respect to each and all. The Commission applied the result of its system-wide calculations to each and all of the 4(e) proceedings and concluded that no refunds were due. Having thus ordered, it concluded ("terminated") the proceedings.

The Commission made no determination of the cost of service of each of these contract rates separately; it had no evidence before it upon which it could make such determinations, and it was of opinion that such computations would be unworkable and foolish under the circumstances.

In these 4(e) cases, as we have pointed out, the Commission was dealing with a locked-in period. The revenues derived from the rates at issue had been impounded. The only question of substance in respect to that period was whether refunds should be made. The Commission decided that question, flatly and directly. No other question remained in those cases for decision. They presented no questions as to rates to be charged. Each presented the question whether a refund was due that customer for that past period and, if so, how much. Having made three determinations—(1) that there was a deficit of some $9,000,000 a year in revenues against cost of service, (2) that the increases involved totaled about five and a half million dollars and so, if allowed in full, would not wipe

[8] Modified to $54,525,315 after rehearing.

out the operating deficit, and (3) that any adjustments should be proportionate to all contract rates—it concluded that no refund was due on any contract, *i.e.*, in any 4(e) proceeding. Section 4(e) pertinently says that the Commission "may" order a refund of "the portion of such increased rates or charges by its decision found not justified." We cannot say that a deficit justifies or requires a refund or that the Commission was unlawfully arbitrary in reaching that result from the premises.

We think the Commission's course was reasonable and tenable. Surely, if only a single rate had been involved, and enough evidence were introduced to justify, under testing, a conclusion that the company was operating at a deficit under that rate, it would not be necessary that evidence be taken to establish the precise penny amount of the deficit in order to support a reasonable inference by the Commission that no refund was indicated. Of course, in the matter at bar a number of rates in separate cases were involved, but the principle of procedure and the scope of permissible inferences from basic facts are much the same as in the suggested illustration. We think the facts support the conclusion.

It is argued that the Commission did not declare the rates under consideration to be just and reasonable or the contrary; that, instead, it "terminated" the proceeding. The contention is that the Commission made no decision. We think the point is not well taken. The Commission did make a clear decision, after elaborate findings, upon the one substantive issue before it. It did say it "terminated" the proceedings, but it terminated them after deciding the basic and dispositive issue, and it entered an order on that decision. Its "termination" was much like that of a judge after he has rendered findings, conclusion and judgment.

Whether the Commission should have preceded its ultimate conclusion of no-refund with an intermediate conclusion of justness and reasonableness in the rates at issue, and whether it properly added the termination order to its decisive finding, seem to us to be immaterial queries.

The important feature is that the Commission reached and decided the critical substantial issue, rationally and upon detailed findings of basic facts upon an ample record.

This is not a *Minneapolis Gas*[9] situation, in which the Commission did nothing but simply terminated the proceeding without passing upon any of the disputed issues before it.

2. The case yields to clearer treatment if we next consider the part of the Commission's treatment which is last in chronological order, that is, the determination of rates for the future. As to these rates the Commission embarked upon the formulation of a new method of fixing just and reasonable rates for producers. It inaugurated hearings for that purpose. We think we need not explore the possibilities of success in that venture, or stop here to describe the projected scheme previously outlined in this opinion. In general it is referred to as an area-price method; it aims to establish proper prices for the gas rather than for the seller thereof. The Congress has confided the regulation of the natural gas industry to the Commission, not to the courts. The Supreme Court has said several times that the Commission is not bound to any one method or to known methods. The regulation of gas producers is a new project. Obviously, as is cogently pointed out in this record, it presents new and complex facts and problems. It would be foolish for the courts to hold that the Commission is bound to apply to these new conditions the methods and measurements designed and used for other and different regulatory purposes. We think it is clear that the Commission had ample authority to embark upon an effort to design suitable new standards for use in the regulation of producers when it found that the tools at hand were not suited to this purpose. The Commission abandoned the pending 5(a) proceeding in which it had been endeavoring to establish rates for the future by methods it now deems

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[9] *Minneapolis Gas Company* v. *Federal Power Commission*, U.S. App. D.C. , 291 F.2d 212 (D.C. Cir., 1961).

inadequate. We see no reason why it should not have done so.

3. The difficult part of the case before us concerns the second, or middle, part of the Commission's disposition. This involves the rates for the period from 1959 until the new system—or a new system—is designed and established. This period will be long, estimates running from four to fourteen years. The rates during this period may, theoretically, be (1) rates in effect without increases having been proposed after January 1, 1959, (2) rates proposed to be increased since that date and suspended under Section 4(e), (3) rates for which increases may be proposed after the present time, (4) initial rates, *i.e.*, rates under new contracts made after January 1, 1959.

To meet the need for interim regulation the Commission took several steps. It published the policy statement which we have described. That announcement contained several components. First, the Commission said that in determining its own *sua sponte* action in respect to rates (*i.e.*, suspending proposed increases or inaugurating inquiries into existing rates) it would be guided by the guide rates. Second, it said that persons attacking rates (*i.e.*, customers and consumers) would be required to present evidence as to the industry generally in the area concerned, as well as the traditional evidence relating to the individual producer involved. Third, it said that "[a]s experience and changing factors may indicate," it would change the areas designated and likewise change the guide prices. Fifth, it said it will use its guide rates in disposing of 4(e) (*i.e.*, suspended proposed increases) proceedings arising upon increases proposed since January 1, 1959.

Refraining from exploring the various arguments, and argumentative trails, pointed out to us by the parties, we come directly to the crux of this problem. Has the Commission power under the Natural Gas Act to do what it did? Can it adopt upon the basis of its own expertise and its files, without a record made in the open in respect to the

specific subject matter in issue, and without hearing, a set of guide lines by which it will be controlled in its regulatory functions during an interim period while it is attempting to perfect a suitable system for permanent regulation? We think it can.

In the first place, and throughout, we must remember that the Congress has power to direct the regulation of interstate commerce, and it has placed that regulatory power over natural gas in the Power Commission. We must remember that the problem at bar concerns a regulatory power. We are not considering adjudicatory, or quasi-judicial power. It has long since been established that rate-making is a legislative function, and it is so defined in the Administrative Procedure Act.

Regulation poses many difficult problems. New regulation poses acutely difficult problems. Solutions oftentimes develop slowly. Many illustrations of that fact could be called to mind.

What power has the Commission in respect to interim regulation while the permanent structure is being designed and erected? Must it use means and methods long established for use in respect to other and different regulatory necessities? Or may it design from its own judgment and accumulated data a new method designed for the new problem? The differences between a public utility, such as a pipeline rendering a service by means of a fixed plant and operation, and a producer, who discovers or buys a product where, when and under such terms as he may, and sells that product under contracts negotiated on the open market, are too evident to justify elaboration. Whether the method thus designed and put into use by the Commission is good or bad is no part of our problem. Our inquiry is whether it was within the orbit of statutory authority and whether it was within constitutional limitations. We turn to those questions.

The Natural Gas Act is broad in its bestowal of power. It declares that all rates demanded by a company in connection with the sale of gas in interstate commerce for resale

shall be just and reasonable. Section 4(a). A gas company files with the Commission schedules of its rates. Section 4(c). If a company proposes to increase a rate, it must file a new schedule. The Commission may then enter upon a hearing concerning the "lawfulness" of the proposed rate. Section 4(e). If the Commission, on its own motion or upon complaint, finds a rate unjust, unreasonable, unduly discriminatory or preferential, the Commission "shall" determine the just and reasonable rate. Section 5(a). Of course, constitutional restrictions apply; rates fixed by governmental authority cannot be confiscatory; all procedures must be by due process, that term conveying meanings differing according to the basic nature of the proceeding but always including that which is fair and decent according to the standards of our social order and time.

The statute contains no definition of a "just and reasonable" rate. It is established by tradition and by many court decisions that for a public utility, rendering service by use of fixed equipment, a just and reasonable rate is one which returns a fair profit upon the investment, or which supplies the utility with adequate revenues to command needed funds upon an economically reasonable basis. But what of a fair price for a commodity bought and sold by a merchandiser? Almost the whole of the economics of merchandising differs from the economics of public utility service. Are the just and reasonable prices of such a merchandiser limited to fair returns on his own investment and prices paid by him (and, if so, what investment and what prices), or are those prices reasonably measured by the fair prices for the product as measured by the open competitive market for the product, evaluated by Commission expertise and data on the whole of the market operation? Either criterion is a method of regulation. It seems to us that the choice must lie with the Commission.

Let us emphasize that we do not have before us at this time the question whether any rate set by the Commission as a guide rate falls within the area of reasonable compu-

tation. That question is emphatically left open by the Commission, and by us, for consideration when some one or more of the selected guide rates is attacked, by a producer, a customer, or a consumer. The problem here at this time is merely whether the Commission may embark upon this method of regulation. Since it is the Commission's judgment that this method is best suited for the regulation of these prices, for the determination of their justness and reasonableness, we find in the statute nothing to deny a trial of the method.

Of course, conceivably, justness and reasonableness from the standpoint of the consumer might be defined as limiting the vendor's return to a fair amount on his investment, and his price accordingly. But, if the government agency charged with the responsibility in the public interest finds, after elaborate accumulation of data, that such a measurement is unworkable, may not a fair price for the product reflected on the open market, after scrutiny and adjustment by the government agency concerning the factors which produced that price, be just and reasonable for the consumer? Of course the agency would be required to be alert for artificial impulses in such a fair area price, and the avenues of attack by consumers would have to be kept open without obstruction; but, if the latter is avowed, how could we assume in advance that the agency would not protect the consumer as it is charged by the Congress to do? The Commission is not here proposing to accept a field price, or any other price as is. It has announced guideline rates which it deems to be, on the basis of the internal data in its files on all the operators in the several areas, fair rates for the product in those areas. Such rates, thus determined, would seem to be just and reasonable rates for the consumers of the product. And, similarly, they would seem to be just and reasonable charges for the producers to make.

As to the constitutional question of confiscation, it would seem to us that the question should await the proof presented by a producer in respect to a particular rate in a particular area.

Thus we come to conclude that the interim method of regulation proposed by the Commission does not appear at this point in the process to be violative of either statutory or constitutional limitations.

It is urged upon us that the Commission has abandoned regulation of these rates for this interim period. We do not agree with that view. It has certainly changed the method of regulation, or, more precisely, the standards by which it will apply its regulatory power. It has abandoned case-by-case, contract-by-contract measurements on a cost-of-service rate-base basis. It has installed an area fair price measurement for the prices of the product to be sold. In so doing it has abandoned a method it finds to be unworkable and foolish in favor of a method it deems to be workable and just and reasonable. If that be so, instead of abandoning regulation it is making regulation effective. The choice it faced, at least in its own view, was not between regulation or no regulation but was between effective and ineffective regulation.

If, as some consumer interests fear, the new process turns out to be ineffective in the protection of their interests, the way is open for them to challenge the results; as we have pointed out, that way must be kept open. New rates and increases in rates proposed during this interim will be subject to suspension and refund, and so the rights of customers will be fully protected. The new method will also apply in 5(a) proceedings to any existing rate found to be unjust or unreasonable. Refunds cannot be ordered in the latter cases and so consumers bear the disputed rates during the period of the inquiry. But this same situation obtains in the present process of regulation; the application of the new criteria makes no change in this procedural aspect. In the case at bar the Commission has found, after elaborate consideration, that present rates result in deficits to the Company. Consumers have no tenable ground for complaint of such rates. So it seems to us that the interests of consumers are amply protected

during this interim period: at least a contrary effect should await the event for us to disturb the view of the Commission, based as it is upon this record.

There remains for discussion a point concerning two 4(e) proceedings which were not terminated. They involved proposed increases based upon escalator clauses in two of Phillips's contracts. These contracts were made before producers such as Phillips were subject to regulation. They were with pipeline companies, as customers, which were subject to regulation. The contracts provided that, if the pipeline companies were granted increases in the rates they could charge, Phillips in turn would receive increases in the rates it charged these customers. These customers had proposed increases, and they were pending in 4(e) proceedings. The Commission ordered that upon decisions in the customers' rate cases Phillips's cases would be acted upon.

Wisconsin and California contend that the Commission should now declare these escalator clauses to be illegal and void as against public policy. As a matter of fact the Commission has declared these clauses to be against the public interest and that they should be held inoperative. But, the Commission says, in so far as these cases of Phillips are concerned, action of the sort demanded by Wisconsin and California is premature. Action on these clauses, it says, should await action on the pending cases which in orderly processes present the problem for decision. We agree with the Commission.

Affirmed.

FAHY, *Circuit Judge, dissenting, with partial concurrence:* I am not able to agree that the order of the Commission terminating the section 4(e)[1] and section 5(a)[2] proceedings should be affirmed. I think the cases should be remanded to the Commission for decision.

While the Commission advances strong reasons for abandoning cost of service as a method of determining the justness and reasonableness of the rates of independent producers of gas, a careful reading of the Commission's opinion demonstrates that the Commission's conclusion that such a method is unworkable follows from a generalized view of the problem of producer rates rather than from the inability of the Commission to utilize the cost of service method in these Phillips cases.

Embarkation upon the area method preferred by the Commission does not necessitate judicial intervention, certainly not at this time; for judicial review must await a Commission order based upon that method. We should not seek to deter the Commission from pursuing such a method in future proceedings, or from using it in any proceedings already initiated along those lines. But it does not follow in my opinion that the Commission should be affirmed in failing to decide the present cases, though it may need to update the record. In the same breath as it were in which it describes the unworkability of the cost of service method the Commission itself accepts that precise method in finding that no refunds are to be required in the section 4(e) proceedings, stating:

> While we have found that the rate base method is not an effective means of regulating the producers' prices, evidence in this proceeding was presented almost entirely upon the cost basis and, of course, there were no ceiling prices issued by us at the time of the hearing. There was some field price evidence introduced, but if field prices could be employed in arriving at rates for Phillips, the evidence was incomplete and unrepresentative of Phillips' diverse sales. Therefore we shall proceed on

---

[1] 52 STAT. 822 (1938), 15 U.S.C. § 717c (1958).

[2] 52 STAT. 823 (1938), 15 U.S.C. § 717d (1958).

> the basis of the evidence adduced in this case to reach conclusions, as reasonable, intelligent and logical as possible even though we know and have herein stated the difficulties inherent in determining a cost of service for Phillips using the rate method. This is clearly a lawful way to determine rates for Phillips as illustrated by the *City of Detroit* case,[11] and under the present record is the only possible method, and therefore we shall make every effort to reach a result by this means.
>
> [11] *City of Detroit* v. *F.P.C.*, 230 F. 2d 810 (CADC), *certiorari* denied, 352 U.S. 829.

The Commission could as well have proceeded, with supplemental data, to decide the question of justness and reasonableness of the rates in the section 4(e) proceedings, and, also, to have determined under section 5(a) the just and reasonable rates to be thereafter observed and enforced.

This view is strongly fortified by the able decision of the Presiding Examiner. After an illuminating analysis of the voluminous record made on a cost of service basis he was able to propose definitive decisions. The record had been made with the cooperation of all parties, Phillips itself affirmatively acquiescing in the position that cost of service was the appropriate basis on which to proceed. Phillips' position, as the Examiner points out, was that its jurisdictional rates should be determined upon the basis of an overall cost of service.

It is one thing to say, as the Commission does, that the area method should hereafter be adopted, or even adopted in other cases which have not proceeded as far as those before us. It is quite another thing to say that the latter should not be decided under the standards of the Act because the area method was not used in preparing the record. Unless decided Phillips' challenged rates are left undetermined under the standards of the Acts since 1948, and apparently will continue to remain undetermined until some future day when new proceedings, now in an inchoate

status with no end in sight, are concluded. Difficult and complicated as the tasks of the Commission admittedly are I cannot agree after reading the Examiner's decision or the Commission's findings that the congressional mandate of section 4(e), which requires that these matters shall be decided "as speedily as possible," is being complied with, or that the responsibilities of the Commission under the Act are discharged in the situation resulting from the termination order.

These cases need not be treated as if they were ventures initiated in search of an ideal method of regulating the rates of independent gas producers. Having in mind the history of these proceedings, and the primary congressional purpose of consumer protection, it seems to me that decisions on the present record, supplemented as may be found to be reasonably necessary, would be far more likely to approximate fulfillment of the purposes of the Act than are the termination order and the resulting situation.

The Commission says it has a discretion to terminate as well as to initiate; but once it has exercised its discretion to initiate and has pursued the matter to the extent we find here its discretion to terminate is not as broad as was its discretion to initiate. The former becomes limited by the conditions existing at the time of its exercise. *Minneapolis Gas Co. v. Federal Power Comm'n.*——U.S. App. D.C.——, 294 F.2d 212. Compare *Eastern Air Lines, Inc. v. Civil Aeronautics Board*, —— U.S. App. D.C.——, 294 F.2d 235.

The Commission has actually found Phillips' cost of service on the basis of the record made and has arrived on the same record at a proper rate of return, stating "this is clearly a lawful way to determine rates for Phillips as illustrated by the *City of Detroit* case, . . . and under the present record is the only possible method . . . ." In this manner the Commission has come so close to doing what it says it should not do as to demonstrate that it is able to do what it has failed to do.

The finding of the Commission in the section 4(e) proceedings that there could be no refunds because the cost

of service exceeded the revenues on the basis of the data for the 1954 test year, I think does not justify the order terminating all but two of the section 4(e) proceedings, or the Commission's invitation to Phillips to move to terminate all others which are still pending. The absence of a decision on the issue of justness and reasonableness of rates has the effect of leaving all rates subsequent to 1954 untested under the standards of the Act. Substance is not achieved merely by finding whether or not refunds were due on the basis of the 1954 data. A finding in that regard should not be independent of a finding of the just and reasonable rates. The former should follow from the fact that the just and reasonable rates are not exceeded by those in effect.

The decision of these cases under the standards of the Act not only would not preclude the Commission from embarking upon the area method, but it also would not preclude the Commission from correcting or modifying the decision should the area proceeding show such correction or modification to be desirable; nor do I think a decision on the present record, supplemented as may be needed, would preclude the Commission, pending conclusion of an area proceeding, from establishing guides, formulated however, with the aid of a decision in the present proceedings.

I agree with Judge Prettyman as to the prematurity of the request for action on two section 4(e) proceedings which have not been terminated.

APPENDIX B.

Judgment.

(Filed November 30, 1961.)

UNITED STATES COURT OF APPEALS,

FOR THE DISTRICT OF COLUMBIA CIRCUIT.

SEPTEMBER TERM, 1961.

No. 16,175.

STATE OF WISCONSIN AND PUBLIC SERVICE COMMISSION OF WISCONSIN,

Petitioners,

v.

FEDERAL POWER COMMISSION,

Respondent,

PHILLIPS PETROLEUM COMPANY,

Intervenor.

No. 16,177.

LONG ISLAND LIGHTING COMPANY, *et al.*,

Petitioners,

v.

FEDERAL POWER COMMISSION,

Respondent,

PHILLIPS PETROLEUM COMPANY,

PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK,

Intervenors.

B-2

No. 16,180.

PEOPLE OF THE STATE OF CALIFORNIA AND PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA,

Petitioners,

v.

FEDERAL POWER COMMISSION,

Respondent,

PHILLIPS PETROLEUM COMPANY,

Intervenor.

On Petitions for Review of Order of the Federal Power Commission.

Before:

PRETTYMAN, FAHY and DANAHER,

Circuit Judges.

JUDGMENT.

These cases came on to be heard on the record from the Federal Power Commission, and were argued by counsel.

ON CONSIDERATION WHEREOF, It is ordered and adjudged by this court that the order of the Federal Power Commission on review in these cases is affirmed.

Per Circuit Judge PRETTYMAN.

Dated: November 30, 1961.

Separate dissenting opinion by Circuit Judge Fahy, with partial concurrence.

APPENDIX C.

Comparison of Average Unit Costs with Average Unit Revenues for All Major Producers whose FPC Rate Cases Have Progressed to Briefing or Decision.

Producer	Rate Case Cost Data: Docket	Test Year	Exhibit	Average Cost[6] (¢ per Mcf)	Average Revenue[6] (¢ per Mcf): 1954	1957	1960	Per Cent Increase 1957-60	1960 Revenue[5]: Total	Collected Subject to Refund	Collected Not Subject to Refund Amount (9)—(10)	Per Cent of Total (11) ÷ (9)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
Amerada Petroleum Corp.	G-18634	1957	61	13.4¢[1]	9.2¢	11.7¢	13.5¢	15.4%	$ 5,300,016	$ 418,786	$ 4,881,230	92.1%
Cities Service Co.	G-12780	[3]	[3]	[3]	[3]	[3]	17.7	[3]	8,972,261	1,053,599	7,918,662	88.3
Continental Oil Co.	G-16968	1955	FPC Staff Reply Brief	11.0	8.9	10.8	17.9	65.7	13,000,859	554,389	12,446,470	95.7
Gulf Oil Corp.	G-17813	1957	112	9.4¢*[1]	9.6¢	11.5¢	15.4¢	33.9	29,028,130	4,727,179	24,300,951	83.7
Hunt Oil Co.	G-10414	1957	38	11.0	11.5	16.5	18.4	11.5	4,736,170	1,076,876	3,659,294	77.3
Ohio Oil Co.	RI60-92	1958	35	13.0¢	9.2	11.6	13.6	17.2	9,797,875	748,787	9,049,088	92.4
Phillips Petroleum Co.	G-1148	1954	Opinion 338	11.1	8.9	10.3	14.3	38.8	90,859,248	20,590,015	70,269,233	77.3
Shell Oil Co.	RI60-111	1959	44	19.3¢*[1]	10.3	11.9	18.9	58.8	55,434,867	11,831,373	43,603,494	78.7
Sohio Petroleum Co.	G-18355	1958	51	15.2¢[1]	9.0	9.7	19.0	95.9	4,749,664	2,581,297	2,168,367	45.7
Sun Oil Co.	G-18353	1957	67	12.3¢[1]	8.6	12.0	16.0	33.3	17,524,295	1,981,586	15,542,709	88.7
Texaco, Inc.	G-8969	1956	104	8.5	10.8	15.3	17.8	16.3	31,835,212	2,885,156	28,950,056	90.9
Tidewater Oil Co.	G-13310	1957	FPC Staff Brief	10.7¢[1]	10.0	14.1	18.2	29.1	17,903,668	2,936,339	14,967,329	83.6
Union Producing Co.	G-18354	1958	51	8.4¢[1]	7.1	9.8	12.8	30.6	17,840,692	1,638,535	16,202,157	90.8

* Production taxes estimated.

[1] Using methods adopted by Respondent in Opinion No. 338 herein.

[3] Company not in existence in its present form in 1954 and 1957.

[4] Excludes Warren Petroleum Corp.

[5] Excludes revenues from sales made under other producers' rate schedules.

[6] Cost and revenue figures are not directly comparable, but are included to show approximate order of magnitude.

Source: (5) (6) and (7): Federal Power Commission, *Direct Sales by Producers of Natural Gas to Interstate Natural Gas Companies*, 1954, 1957 and 1960.

(9) and (10): F. P. C. Form 301 A for year ended 12/31/60.

APPENDIX D

Comparison of FPC Area Price Levels Set Forth in SGP61-1 with Highest Accepted Rate on File with FPC as of September 19, 1960, for Permanently Certificated Sale.

FPC Pricing Area	SGP61-1 Price Level for New Gas	Highest Permanently Certificated Rate as of Sept. 1960*	Comment or Explanation
Texas Dist. 1	15.0¢	14.7¢	
" " 2	18.0	18.0	
" " 3	18.0	20.0	See Note 1
" " 4	18.0	18.0	
" " 5	14.0	—	
" " 6	15.0	14.6	
" " 7B	14.0	10.5	See Note 2
" " 7C	16.0	16.0	
" " 8	16.0	16.0	See Note 3
" " 9	14.0	14.0	
" " 10	17.0	17.0	
So. Louisiana	21.5	22.0	See Note 4
No. Louisiana	17.0	18.5	See Notes 4, 5
Mississippi	21.5	21.5	
Okla.—Panhandle	17.0	17.0	
" Carter-Knox	16.8	16.8	
" Other	15.0	15.5	
Kansas	16.0	16.0	
N. M.—Permian	16.0	16.0	See Note 3
—San Juan	12.7	12.7	See Note 6
Colorado	14.6	16.0	See Note 7
Wyoming	15.0	15.0	

* Excludes rates authorized under temporary authority and rates for sales to commence more than three years in future.

Source: Adapted from F. P. C. Staff Exhibit No. 9 (*Ohio Oil Co.*, G-15385), as expanded and annotated from F. P. C. records.

NOTES

1. Prior to the announcement of the SGP levels in September 1960, the FPC had breached the 18¢ level in District 3 only twice—in *Peoples Gulf Coast*, G-19086, and in *Trunkline* G-15394. In both instances, certification came after the Public Service Commission of New York had been excluded. New York's exclusion from *Peoples Gulf* was subsequently reversed, 295 F. 2d 140 (D. C. Cir.

1961), thereby vacating the 20¢ certification in that case. Although New York's appeal from its *Trunkline* exclusion was dismissed as not timely filed, 284 F. 2d 200 (D. C. Cir. 1960), because of the circumstances surrounding New York's exclusion, the FPC does not regard the Trunkline levels as precedents. See brief of Federal Power Commission, filed February 12, 1962, in *Hunt et al* v. *F. P. C.*, 5th Cir. Nos. 19065 et al, pp. 11-18.

2. District 7B appears to be the only area where the SGP level (14.0¢) departs significantly from the prior high to 1960 (10.5¢). By way of possible explanation, we note the following: (1) by 1960, the 10.5¢ level was quite old, having been established many years previously; (2) very few new sales had been undertaken from District 7B in recent years; and (3) the SGP level for the two neighboring Districts, 7C and 8, is 16.0¢.

3. As of September 1960, the highest permanently certificated *wellhead* price for the Permian Basin of New Mexico and Texas District 8, which adjoins it, was 16.0¢ per Mcf. In August 1959, the FPC had authorized the sale of gasoline plant *residue gas* at 18.0¢ per Mcf, *Transwestern Pipeline Company*, 22 F. P. C. 391; the Transwestern opinion specifically notes that 16.0¢ was the highest wellhead price in the area.

4. The Louisiana prices are shown exclusive of tax reimbursement since this is the way in which they are shown by the FPC's Statement of General Policy. The Southern Louisiana price was modified slightly after the issuance of several Court of Appeals decisions reversing certifications at the level originally stated.

5. The only North Louisiana price in excess of 17.0¢—a single sale by Gulf Oil at 18.5¢—was apparently certificated in error; see Examiner's Decision in *Ohio Oil Company et al*, FPC Docket Nos. G-15385 et al, issued November 8, 1961, Mimeo., pp. 19-21.

6. In addition, the FPC had certificated a 15.9¢ sale in the San Juan Area for *gathered* gas; this price includes a gathering charge of at least 4.4¢. Southern Union Gathering Company Rate Schedule No. 1; see *Southern Union Producing Company*, G-7670, 14 F. P. C. 1220.

7. Includes 1¢ pressure adjustment. Moran Brothers, Inc., Rate Schedule No. 2.

APPENDIX E.

Natural Gas Act.

The pertinent provisions of the Natural Gas Act of June 21, 1938, c. 556, 52 Stat. 821; as amended, 15 U. S. C. §§ 717-717w, are as follows:

SECTION 4. (a) All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.

* * * * * * *

(d) Unless the Commission otherwise orders, no change shall be made by any natural-gas company in any such rate, charge, classification, or service, or in any rule, regulation, or contract relating thereto, except after thirty days' notice to the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. The Commission, for good cause shown, may allow changes to take effect without requiring the thirty days' notice herein provided for by an order specifying the changes so to be made and the time when they shall take effect and in the manner in which they shall be filed and published.

(e) Whenever any such new schedule is filed the Commission shall have authority, either upon complaint of any State, municipality, or State commission, or upon its own initiative without complaint, at once, and if it so orders, without answer or formal pleading by the natural-

gas company, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the natural-gas company affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect: *Provided*, That the Commission shall not have authority to suspend the rate, charge, classification, or service for the sale of natural gas for resale for industrial use only; and after full hearings, either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made at the expiration of the suspension period on motion of the natural-gas company making the filing, the proposed change of rate, charge, classification, or service shall go into effect. Where increased rates or charges are thus made effective, the Commission may, by order, require the natural-gas company to furnish a bond, to be approved by the Commission, to refund any amounts ordered by the Commission, to keep accurate accounts in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts were paid, and, upon completion of the hearing and decision, to order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the natural-gas company, and the Commission shall give to the hearing and decision of such questions prefer-

ence over other questions pending before it and decide the same as speedily as possible.

[52 Stat. 822 (1938); 15 U. S. C. §717c]

* * * * * * *

Section 5. (a) Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: *Provided, however*, That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural-gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural-gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates.

[52 Stat. 823 (1938); 15 U. S. C. §717d]

* * * * * *

Section 19. (a) . . .

(b) Any party to a proceeding under this chapter aggrieved by an order issued by the Commission in such proceeding may obtain a review of such order in the court of appeals of the United States for any circuit wherein the natural-gas company to which the order relates is located or has its principal place of business, or in the United States Court of Appeals for the District of Columbia, by

filing in such court, within sixty days after the order of the Commission upon the application for rehearing, a written petition praying that the order of the Commission be modified or set aside in whole or in part. A copy of such petition shall forthwith be transmitted by the clerk of the court to any member of the Commission and thereupon the Commission shall file with the court the record upon which the order complained of was entered, as provided in section 2112 of Title 28. Upon the filing of such petition such court shall have jurisdiction, which upon the filing of the record with it shall be exclusive, to affirm, modify, or set aside such order in whole or in part. No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission in the application for rehearing unless there is reasonable ground for failure so to do. The finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. If any party shall apply to the court for leave to adduce additional evidence, and shall show to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence in the proceedings before the Commission, the court may order such additional evidence to be taken before the Commission and to be adduced upon the hearing in such manner and upon such terms and conditions as to the court may seem proper. The Commission may modify its findings as to the facts by reason of the additional evidence so taken, and it shall file with the court such modified or new findings, which if supported by substantial evidence, shall be conclusive, and its recommendation, if any, for the modification or setting aside of the original order. The judgment and decree of the court, affirming, modifying, or setting aside, in whole or in part, any such order of the Commission, shall be final, subject to review by the Supreme Court of the United States upon certiorari or certification as provided in section 1254 of Title 28.

[52 Stat. 831 (1938), as amended, Aug. 28, 1958, Pub. L. 85-791, §19, 72 Stat. 947, 15 U.S.C. §717r.]

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In the Supreme Court of the United States

OCTOBER TERM, 1962

No. [redacted] '73

PEOPLE OF THE STATE OF CALIFORNIA and
PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA,
Petitioners,

vs.

FEDERAL POWER COMMISSION,
Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

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In the Supreme Court of the United States

OCTOBER TERM, 1961

No. [illegible]

PEOPLE OF THE STATE OF CALIFORNIA and
PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA,
Petitioners,

vs.

FEDERAL POWER COMMISSION,
Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

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The Petitioners, the People of the State of California and the Public Utilities Commission of the State of California, respectfully pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the District of Columbia Circuit entered in the above-entitled case on November 30, 1961.

OPINIONS BELOW

The opinion of the Court of Appeals, Docket Nos. 16175, 16177 and 16180, decided November 30, 1961 (Appendix A), is not yet reported. The Federal Power Commission's Opinion and Order Determining Cost of Service and Terminating Proceedings, issued on September 28, 1960 (R. 32643-32709) and its Order Denying Applications for Rehearing, Amending Opinion and Rejecting Application for Rehearing, issued on Novem-

ber 25, 1960 (R. 32897-32904), in the proceeding entitled *In the Matters of Phillips Petroleum Company*, Docket Nos. G-1148, *et al.*, are reported at 24 F.P.C. 537 (1960) and 24 F.P.C. 1008 (1960).

JURISDICTION

The judgment of the Court of Appeals was entered on November 30, 1961. Petitioners herein did not petition for rehearing before the Court of Appeals.[1] Consequently, the court's judgment became final on December 15, 1961. The jurisdiction of this Court is invoked under the provisions of 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act.[2]

QUESTIONS PRESENTED

1. Where Sections 4 and 5 of the Natural Gas Act provide a just and reasonable standard for the testing of rates of natural gas producers, may the Federal Power Commission terminate proceedings under said statutes and allow the rates at issue to become effective without a finding relative to their justness and reasonableness?
2. Where the Court of Appeals, affirmed by this Court, has ordered the fixing of rates in accordance with the just and reasonable standard, may the Federal Power Commission, in remanded proceedings, terminate the proceedings without fixing the rates as so ordered?
3. Where Sections 4 and 5 of the Natural Gas Act provide for hearings for the fixing of just and reasonable rates, may the Federal Power Commission promulgate a list of rate levels as just and reasonable when said list was developed without notice, hearings, and the taking of evidence?

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[1]Rule 26 of the United States Court of Appeals for the District of Columbia Circuit allows fifteen days after judgment or decision to petition for rehearing.

[2]Act of June 21, 1938, c. 556, § 19, 52 Stat. 831, as amended 15 U.S.C. 717r (b) (1958).

4. Where spiral escalation clauses in a natural gas producer's contracts are unacceptable in principle and unlawful in a regulatory setting, may the Federal Power Commission refuse to reject rate increase filings based thereon?
5. Where the cost of service method is the only approved, existing, and workable means of regulating natural gas producers, may the Federal Power Commission abandon said method without substituting a method which will provide lawful regulation while new procedures are being developed?
6. Where the Congress has provided for the regulation of natural gas producers under the Natural Gas Act, may the Federal Power Commission by interminable delay prevent said regulation from becoming a reality and substitute further experimentation for presently valid regulation?

STATUTES INVOLVED

The relevant parts of the statutes involved are set forth in the Appendix B. Citations to them are:

1. Administrative Procedure Act, Act of June 11, 1946, c. 324, 60 Stat. 235, 5 U.S.C. § 1000; § 5, 5 U.S.C. §1004; § 8(b), 5 U.S.C. § 1007(b).

2. Natural Gas Act, Act of June 21, 1938, c. 556, 52 Stat. 821, as amended 15 U.S.C. § 717; § 1(a), 15 U.S.C. § 717(a); § 4, 15 U.S.C. § 717c; § 5, 15 U.S.C. § 717d; § 19(b), 15 U.S.C. § 717(r)(b).

STATEMENT OF THE CASE

A. Original Proceedings before the Commission and the Courts.

On October 28, 1948, the Federal Power Commission (Commission) instituted, on its own motion, an investigation to determine (1) whether Phillips Petroleum Company (Phillips) was a natural gas company within the Commission's jurisdiction, and (2) if so, whether Phillips' existing rates were unjust and

unreasonable. (R. 26148-50). This investigation, designated Docket No. G-1148, was initiated pursuant to Section 5(a) of the Natural Gas Act.[3]

Hearings commenced in April, 1951, and were directed solely to the jurisdictional issue. In August, 1951, the Commission found that Phillips was not a natural gas company within the meaning of the Act and, in accordance with this finding, terminated the investigation. *In the Matter of Phillips Petroleum Company*, 10 FPC 246 (1951).

The United States Court of Appeals for the District of Columbia Circuit, in May, 1953, reversed the Commission and ordered it to "fix the rates at which these sales [by Phillips] are made." *State of Wisconsin v. Federal Power Commission*, 205 F.2d 706, 712 (D.C. Cir. 1953). This Court, in June, 1954, affirmed the judgment of the Court of Appeals. *Phillips Petroleum Company v. Wisconsin*, 347 U.S. 672 (1954).

B. Remanded Proceedings Before the Commission.

In compliance with the judicial mandate the Commission, in November, 1954, resumed its investigation (R. 32931-32). This time the investigation would be focused on the second issue—the justness and reasonableness of Phillips' rates.

By later orders the Commission consolidated with the Section 5(a) investigation twelve docketed rate increase filings of Phillips under Section 4(e) of the Act.[4]

Hearings commenced in June, 1956, and were conducted intermittently before a presiding examiner until December, 1957. Therefore, the Commission's first effort to regulate the rates of a major natural gas producer began eight years after the original order instituting the investigation and eighteen years after the enactment of the Natural Gas Act. The hearings consumed eighty-two days and produced over 25,000 pages of record.

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[3] 52 Stat. 823 (1938); 15 U.S.C. § 717d(a).

[4] 52 Stat. 822 (1938); 15 U.S.C. § 717c(e).

C. The Presiding Examiner's Decision.

The Presiding Examiner issued his decision in April, 1959, sixteen months after the conclusion of the hearings. (R. 31324-654). Following an established line of decisions beginning with *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591 (1944), and including *City of Detroit, Michigan v. Federal Power Commission*, 230 F.2d 810 (D.C. Cir. 1955), cert. denied 352 U.S. 829 (1956), *Bel Oil Corporation v. Federal Power Commission*, 255 F.2d 548 (5th Cir. 1958), cert. denied 358 U.S. 804 (1958), and *Forest Oil Corporation v. Federal Power Commission*, 263 F.2d 622 (5th Cir. 1959), the examiner decided that conventional cost of service, or rate base method, was the lawful way to test the justness and reasonableness of Phillips' rates. (R. 31340-47). All parties, including Phillips, had agreed to and had participated in the conduct of the proceeding along cost of service lines.[3] The examiner stated that "the length and complexity of the instant *Phillips* proceeding cannot fairly be regarded as representative of the situation which will be commonly encountered in future rate proceedings * * *." (R. 31352).

The decision called upon Phillips to calculate new rates, based on a cost of service of $57,280,218, for each of its current jurisdictional rate schedules. These "calculated rates", if approved by the Commission, would constitute maximum rates for the consolidated Section 4(e) filings.

The examiner's decision demonstrates that just and reasonable rates can be developed for a producer of natural gas—in this case the nation's largest—on a cost of service basis.

Oral argument was held before the Commission in October, 1959 (R. 16894-7140).

D. The Commission's Opinion.

In September, 1960, the Commission issued Opinion No. 338 (R. 32643-709) which terminated ten of the twelve Section 4(e) proceedings and the Section 5(a) investigation. The Commis-

[3]Thirty-one parties intervened in the proceeding before the Commission.

sion, while not deciding the issue of the justness and reasonableness of Phillips' rates, discharged the company from any obligation to make refunds.

The Commission, using the cost of service approach, found that Phillips' revenues for the test year 1954 fell about $10,000,000 below the $55,548,054[6] cost of service which the Commission computed for that year. (R. 32693). Because of this deficiency in revenue, the Commission excused Phillips from making refunds respecting the Section 4 (e) increases. This action was taken, the Commission said, because nine of the ten dockets had been superseded by new filings for even higher rates and that the now "locked-in" rates should be bypassed. The Commission stated: "[I]t would appear that on the basis of the present record that Phillips' costs probably exceed its revenues at least up through the year 1958, after which very substantial further rate increases were filed by Phillips." (R. 32695).

Upon this assumption that Phillips did not recover its cost of service through 1958, the Commission invited Phillips to move to dismiss the Section 4 (e) proceedings "on the theory that little or nothing would be accomplished if hearings were held and a determination of Phillips' costs in each case were made." (R. 32695).

Three of the Section 4 (e) dockets concerned rate increase filings based on the activation of spiral escalation clauses.[7] Docket No. G-11217, involving a sale to El Paso Natural Gas Company, and Docket No. G-10883, involving a sale to Panhandle Eastern Pipe Line Company, were left open pending the final determination of the rates of these pipeline companies in other proceedings. However, the rate increase in Docket No. G-10793, covering a sale to Michigan-Wisconsin Pipe Line Company, was approved by the Commission. (R. 32695). By keeping the former open only on the issue of the amount of increase and by approving the latter, the Commission placed a stamp of legality on spiral escalation clauses.

[6]On rehearing, this figure was changed to $54,525,315. (R. 32901).

[7]Spiral escalation clauses are discussed on pages 25-27.

The Section 5 (a) investigation was terminated because the Commission did not "think that it is appropriate to set rates for the future on the basis of this record in this hearing that terminated December 18, 1957, utilizing a test year of 1954 or 1956 * * *." (R. 32656).

In using the cost of service approach the Commission said that this was "clearly a lawful way to determine rates for Phillips as illustrated by the *City of Detroit* case, and under the present record is the only possible method, and therefore we shall make every effort to reach a result by this means." (R. 32655). Furthermore, the Commission said: "In the present proceedings we are as a matter of law permitted to reach results by this method." (R. 32655). However, in the same breath, it also said that such an approach was not a sensible, or even a workable, method of fixing rates for producers of natural gas. (R. 32647).

The Commission used its opinion to announce that it was considering the possibility of pricing natural gas as a commodity, on an area basis, thereby avoiding the necessity of regulating producers individually. (R. 32647-54). It made reference to its Statement of General Policy No. 61-1, issued simultaneously with the opinion. (R. 32710-13). The Statement sets maximum price levels for initial and increased rates to be used as guides in determining whether proposed initial rates should be certificated without condition and whether proposed rate changes should be accepted or suspended. (R. 32710).

These price levels were promulgated, presumably under the authority of the Natural Gas Act, without notice, hearings, and the taking of evidence. They were intended to be guides in all subsequent producer rate matters pending the outcome of the Commission's experiments in the area, or commodity, pricing of gas.

Petitioners filed a timely petition for rehearing (R. 32763-71) which was denied by the Commission in November, 1960. (R. 32897-904).

E. Proceeding in the Court Below.

Pursuant to Section 19 (b) of the Natural Gas Act Petitioners obtained court review of the Commission's orders.

The court, Judge Fahy dissenting with partial concurrence, upholds the Commission's position that the cost of service method of regulation is not a sensible, or even workable, means of fixing producer rates. (App. A, p. 5). It points out that cost of service, by limiting producers to a fair return on investment, penalizes the efficient and fortunate producer who keeps his costs low. The method itself, the majority says, produces problems in the allocation of costs between gas and oil and is a burden on the administrative agency. Nevertheless, the majority agrees with Phillips' cost of service as computed by the Commission. (App. A, p. 10).

On the Commission's termination of the Section 4 (e) dockets, the majority of the court says that the Commission's act was a clear decision, after elaborate findings, upon the issue of refunds. (App. A, p. 11). The majority further says that "[w]hether the Commission should have preceded its ultimate conclusion of no-refund with an intermediate conclusion of justness and reasonableness in the rates at issue, and whether it properly added the termination order to its decisive finding, seem to us to be immaterial queries." (App. A, p. 11).

The majority's opinion makes no reference to an absence of a finding on the justness and reasonableness of Phillips' *existing* jurisdictional rates in the Section 5 (a) investigation. It does point out that the Commission "abandoned" the investigation because it could not establish rates for the *future* by the inadequate cost of service method. (App. A, p. 12). However, the opinion recognizes that, under Section 5 (a), future rates are determined only after the Commission "finds a rate unjust, unreasonable, unduly discriminatory or preferential * * *." (App. A, p. 14).

The court assumes, as did the Commission, that Phillips' costs have exceeded revenues through 1958. This assumption is made even though the court notes that the cost of service adopted was for the single test year 1954. (App. A, p. 9).

Using this assumption, the opinion speaks of an "interim period" between January 1, 1959, and the date when the Commission, or the courts, reach a final determination respecting the area pricing of gas. (App. A, p. 13). It is acknowledged that this period may last as long as fourteen years. (App. A, p. 13). To carry on its duties during this period, the majority says that the Commission may rely on the rate levels in its Statement of General Policy No. 61-1. The court puts the problem this way:

> "Can [the Commission] adopt upon the basis of its own expertise and its files, without a record made in the open in respect to the specific subject matter in issue, and without hearing, a set of guide lines by which it will be controlled in its regulatory functions during an interim period, while it is attempting to perfect a suitable system for permanent regulation? We think it can." (App. A, p. 13).

On spiral escalation clauses the court says:

> "Wisconsin and California contend that the Commission should now declare these escalator clauses to be illegal and void as against public policy. As a matter of fact the Commission has declared these clauses to be against the public interest and that they should be held inoperative. But, the Commission says, insofar as these clauses of Phillips are concerned, action of the sort demanded by Wisconsin and California is premature. Action on these clauses, it says, should await action on the pending cases which in orderly processes present the problem for decision. We agree with the Commission." (App. A, p. 18).

The court makes no reference to the spiral escalation clause in Docket No. G-10793, which docket was not left open but was terminated along with the other Section 4 (e) proceedings.

The dissenting opinion was unable to agree that the order of the Commission terminating the Section 4 (e) and the Section 5 (a) proceedings should be affirmed. The dissent says: "I think the cases should be remanded to the Commission for decision." (App. A, p. 18). On the cost of service issue, Judge Fahy notes:

> "In the same breath as it were in which it describes the unworkability of the cost of service method the Commission itself accepts that precise method in finding that no refunds are to be required in the Section 4 (e) proceedings * * *." (App. A, pp. 18-19).

Speaking of the Commission's proposal to establish commodity pricing on an area basis, he says:

> "It is one thing to say, as the Commission does, that the area method should hereafter be adopted, or even adopted in other cases which have not proceeded as far as those before us. It is quite another thing to say that the latter should not be decided under the standards of the Act because the area method was not used in preparing the record. Unless decided Phillips' challenged rates are left undetermined under the standards of the Act since 1948, and apparently will continue to remain undetermined until some future day when new proceedings, now in an inchoate status with no end in sight, are concluded." (App. A, p. 20).

The dissent insists that the primary purpose of the Natural Gas Act, consumer protection, can be best achieved by remanding the proceeding to the Commission, and supplementing the record as necessary. The dissent says:

> "The absence of a decision on the issue of justness and reasonableness of rates has the effect of leaving all rates subsequent to 1954 untested under the standards of the Act. Substance is not achieved merely by finding whether or not refunds were due on the basis of the 1954 data. A finding in that regard should not be independent of a finding of just and reasonable rates. The former should follow from the fact that the just and reasonable rates are not exceeded by those in effect." (App. A, p. 21).

The dissent concurred with the majority only as to the prematurity of the request for action relating to the spiral escalation clauses.

REASONS FOR GRANTING THE WRIT

Circuit Judge Prettyman characterizes this case as a controversy concerning "major problems of general application." (App. A,

p. 2). This statement is recognition that not only is the regulation of a single natural gas producer involved, but also the regulation of producers generally. The instant case presents the proper situation for this Court, having already ordered the regulation of producers under the Natural Gas Act, to decide for the first time whether or not they, in fact, are being regulated.

The approval by the majority of the court below of the Commission's termination of several rate increase proceedings and a general rate investigation of the nation's largest producer of natural gas, without a decision by the Commission on the basic and ultimate issue before it, is an unjustifiable departure from statutory and judicial mandates.

The statutory mandate is found in both Section 4(e) and Section 5(a). These statutes call upon the Commission to test rates using a standard of "just and reasonable." Disregarding such standard, the Commission allows Phillips' rates to become effective, as if just and reasonable, because (1) Phillips should not be required to make refunds and, (2) the Commission should not be required to use existing procedures for testing rates.

The judicial mandate, which the Commission also disregards, was issued by the same court and affirmed by this Court in *Phillips Petroleum Company v. Wisconsin*, 347 U.S. 672 (1954). The Court of Appeals instructed the Commission to "fix the rates at which these sales [by Phillips] are made." *State of Wisconsin v. Federal Power Commission*, 205 F.2d 706, 712 (D.C. Cir. 1953). Nevertheless, the Commission does not fix Phillips' rates but allows existing rates and new rates to remain effective, as if just and reasonable, without a finding relative to their justness and reasonableness.

The court below and the Commission further err in treating mere guideline rates, established without notice, hearing, and the taking of evidence, and based on field prices, as just and reasonable rates. The determination that a decision on the legality of spiral escalation clauses would be premature is likewise incorrect. The Commission's opinion gave legal effect to these clauses and the court below should have reviewed this issue.

The decision of the majority of the court below to uphold the Commission's rejection of the conventional cost of service approach to rate regulation in future producer cases is erroneous. The instant proceeding is developed through a cost of service method, and, until a new method is designed, cost of service is the only approved, existing, and workable means of carrying out producer regulation.

The court below and the Commission suspend producer regulation until an area, or commodity, pricing of gas is adopted, assuming it is adopted. *No lawful provision is made for regulation during this interim period of development.*

The problems created by the decision of the majority of the court below and by the opinion of the Commission are many, and call for immediate resolution. The law as it exists today with regard to the regulation of natural gas producers is uncertain. A decision in this area by this Court is needed.

The issues presented are heightened by the social and economic interests of the consumers here involved, and by the national importance and significance of this proceeding.

A. The Decision of the Court Below and the Opinion of the Commission Are Contrary to the Intent and Purpose of the Natural Gas Act.

1. THE POLICY UNDERLYING THE ACT HAS BEEN CONTRADICTED.

In Section 1(a) of the Natural Gas Act[5] Congress makes known the compelling reason for federal regulation of the natural gas industry:

> "As disclosed in reports of the Federal Trade Commission made pursuant to Senate Resolution 83 (Seventieth Congress, first session) and other reports made pursuant to the authority of Congress, it is hereby declared that the business of transporting and selling natural gas for ultimate distribution to the public is *affected with a public interest*, and that Federal regulation in matters relating to the transportation of natural gas and the sale thereof in interstate commerce is necessary *in the public interest*." (Emphasis supplied)

[5] 52 Stat. 821 (1938); 15 U.S.C. § 717(a).

In order to serve best the public interest Congress has adopted a policy of consumer protection under the Act. The policy is discussed by this Court in *Atlantic Refining Company v. Public Service Commission of the State of New York*, 360 U.S. 378, 388 (1959):

> "The purpose of the Natural Gas Act was to underwrite just and reasonable rates to consumers of natural gas. * * * The Act was so framed as to afford consumers a complete, permanent and effective bond of protection from excessive rates and charges."

This statement is a reiteration of this Court's view in *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591, 611 (1944). There it is said that the primary aim of the Act is "to protect consumers against exploitation at the hands of natural gas companies."

Congress has delegated to the Commission the duty and responsibility of protecting the consumers of natural gas. As an agency of Congress it is "charged with the enforcement of no policy except the policy of the law." *Humphrey's Executor v. United States*, 295 U.S. 602, 624 (1935). The Commission is obligated to observe the mandate of Congress provided in the Act, as interpreted by the courts.

2. THE ACT CALLS FOR A STANDARD OF JUST AND REASONABLE RATES.

What standard does Congress provide to enable the Commission to protect consumers? Section 4(a)[2] sets forth the only standard:

> "All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission * * * *shall be just and reasonable*, and any such rate or charge that is not *just and reasonable* is hereby declared to be *unlawful*." (Emphasis supplied).

Accordingly, the only lawful rates are those which meet the standard of just and reasonable.

[2] 52 Stat. 822 (1938); 15 U.S.C. § 717c(a)

Following a scheme of consumer protection through the assurance of just and reasonable rates, Congress included Sections 4(e) and 5(a) within the Act. Section 4(e) allows the Commission to suspend proposed rate increases for a maximum period of five months, and then to enter upon a hearing concerning the lawfulness, or justness and reasonableness, of such increases, deciding that issue "as speedily as possible." Upon expiration of the suspension period the rates become effective but subject to refund to the extent they may be found later to be unjust and unreasonable. Section 5(a) gives the Commission the power to investigate existing rates so as to determine whether or not they are just and reasonable. If found just and reasonable they are lawful rates; if found unjust and unreasonable the Commission must determine the lawful rates.

With the exception of the instant proceeding, in the Section 4(e) producer rate cases which have had full hearings and have been decided, the Commission has either made specific findings relative to the justness and reasonableness of rates, or has dismissed the proceedings because the producers failed to make a showing of justness and reasonableness.[10] Likewise, in completed

[10] *Wunderlich Development Co.*, 15 FPC 692 (1956); *Continental Oil Co.*, 15 FPC 735 (1956); *Christie, Mitchell & Mitchell*, 15 FPC 751 (1956); *Davidor & Davidor*, 15 FPC 1936 (1956); *Ohio Fuel Gas Co.*, 15 FPC 1623 (1956); *Union Oil Co. of California*, 16 FPC 100 (1956); *Sun Oil Co.*, 17 FPC 174 (1956); *Associated Oil and Gas Co.*, 17 FPC 174 (1956); *Associated Oil and Gas Co.*, 17 FPC 199 (1956); *Crou Drilling Co., Inc.*, 17 FPC 226 (1957); *William Negley*, 17 FPC 550 (1957); *Forest Oil Corp.*, 17 FPC 586 (1957); *Olin Gas Transmission Corp.*, 17 FPC 685 (1957); *Harper Oil Co.*, 17 FPC 803 (1957); *H. G. Sears*, 18 FPC 244 (1957); *Southwest Gas Producing Co.*, 18 FPC 304 (1957); *Delhi-Taylor Oil Corp.*, 18 FPC 375 (1957); *Pan American Petroleum Corp.*, 19 FPC 463 (1958); *Pan American Petroleum Corp.*, 19 FPC 519 (1958); *H. L. Hunt*, 19 FPC 748 (1958); *Sun Oil Co.*, 19 FPC 973 (1958); *Bateman Drilling Co.*, 20 FPC 341 (1958); *BBM Drilling Co.*, 20 FPC 723 (1958); *Hassie Hunt Trust*, 21 FPC 37 (1959); *Bayview Oil Co.*, 21 FPC 405 (1959); *Sinclair Oil & Gas Co.*, 22 FPC 53 (1959); *Monsanto Chemical Co.*, 22 FPC 1077 (1959); *United Carbon Co.*, 25 FPC 181 (1961); *Murphy Corp.*, 25 FPC 331 (1961).

producer Section 5(a) investigations the Commission has made specific findings relative to the justness and reasonableness of existing rates.[11] Therefore, until the instant case, this was the test applied by the Commission without question.

In the *Atlantic Refining* case[12] this Court states that the purpose of the Act is "to underwrite just and reasonable rates to consumers of natural gas." And in the *Hope* case[13] this Court speaks of the "statutory standard of 'just and reasonable'."

From the literal reading of the statutes, from the past decisions of the Commission, and from the interpretations of this Court, it is evident that the basic and ultimate issue in a proceeding under either Section 4 or Section 5 is the justness and reasonableness of the rates involved. Such is the standard devised by Congress; such is the standard which the Commission must apply in testing increased rates, investigating existing rates, and establishing future rates.

3. THE JUST AND REASONABLE STANDARD HAS BEEN DISREGARDED.

The instant proceeding presents the first and only occasion in which the Commission has not made a just and reasonable determination, or required such a showing, in a Section 4(e) proceeding. This disregard of the statutory standard is supported by the majority of the court below. The court states that the only question of substance involved in the Section 4(e) dockets is "whether refunds should be made." (App. A, p. 10). Furthermore, the court says:

> "Whether the Commission should have preceded its ultimate conclusion of justness and reasonableness in the rates at issue, and whether it properly added the termination order to its decisive finding, seems to us to be immaterial queries." (App. A, p. 11).

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[11] *Gilfring Oil Co.*, 20 FPC 770 (1958); *Ralph E. Fair*, 20 FPC 810 (1958); *C. V. Lyman*, 22 FPC 557 (1959); *Western Natural Gas Co.*, 23 FPC 235 (1960); *Murphy Corp.*, 25 FPC 334 (1961).

[12] *Atlantic Refining Company v. Public Service Commission of the State of New York*, 360 U.S. 378, 388 (1959).

[13] *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591, 602 (1944).

Such a position replaces the just and reasonable finding, demanded by the statute for consumer protection, with a conclusionary statement of whether or not the producer should make refunds.[11] This is analogous to a judge sentencing a defendant without a finding as to his guilt.

Obviously, entirely different factors may be involved in refund accounting than are involved in deciding whether particular rates are just and reasonable. The Commission, for instance, has made provision for offers of settlement whereby natural gas companies may negotiate the extent of the refunds to be paid. FPC Rules and Regulations, Sec. 1.18; 18 C.F.R. § 1.18. Moreover, no rational determination of refunds can be made unless a line is drawn at a lawful level. The majority below and the Commission have excused Phillips from a refund obligation without finding whether the rates being collected were at a lawful level. *This question of the lawfulness of rates was the basic and ultimate issue before the Commission.*

The necessity for findings upon basic and ultimate issues has been discussed by this Court in *Colorado-Wyoming Gas Company v. Federal Power Commission*, 324 U.S. 626, 631, 634 (1945):

> "Here as in the cases of Canadian and Colorado Interstate the findings of the Commission leave much to be desired. The findings are general and incorporate by reference the staff exhibits, on which reliance is put for the subsidiary findings. * * *
>
> "The review which Congress has provided for these rate orders is limited. Section 19 (b) 15 USCA Sec. 717r (b), 4 FCA title 15, Sec. 717r (b) says that the 'finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive.' But we must first know what the 'finding' is before we can give it conclusive weight. We have repeatedly emphasized the need for clarity and completeness in the basic or essential findings on which administrative orders rest. Florida v. United States, 282 US 194,

[11]This Court should consider the contrary situation: Suppose the Commission had ordered Phillips to account for refunds without a finding that Phillips' proposed rates were unjust and unreasonable. Would not Phillips have a valid complaint on statutory, if not constitutional, grounds?

215, 75 L ed 291, 304, 51 S Ct 119; United States v. Baltimore & O. R. Co., 293 US 454, 464, 79 L ed 587, 594, 55 S Ct 268; United States v. Chicago, M. St. P. & P. R. Co., 294 US 499, 504, 505, 510, 511, 79 L ed 1023, 1028, 1029, 1031, 1032, 55 S Ct 462; United States v. Carolina Freight Carriers Corp., 315 US 475, 488, 489, 86 L ed 971, 982, 62 S Ct 722. Their absence can only clog the administrative function and add to the delays in rate making. We cannot dispense with them for Congress has provided the standards for judicial review under this Act. Sec. 19 (b). The courts cannot perform the function which Congress assigned to them in absence of adequate findings. Nor are they authorized under Sec. 19 (b) to make findings and substitute them for those of the Commission."

The court below and the Commission deny Petitioners the specific finding they are entitled to by statute. A conclusion that no refunds are required does not follow from a subsidiary finding that costs exceed revenues in a particular period. Simple logic, if nothing else, demands a basic and ultimate finding respecting the lawfulness of the rates at issue before the conclusion is made.

Turning to the Commission's Section 5 (a) investigation, it is important to note that the investigation was intended to be an examination of all of the jurisdictional rates of Phillips for the sole purpose of determining the lawfulness of such rates. The court below says the "Commission abandoned the pending 5 (a) proceeding in which it had been endeavoring to establish rates for the future by methods it now deems inadequate." (App. A, p. 12). The Commission says it terminated the investigation because it does not "think that it is appropriate to set rates for the future on the basis of this record in this hearing * * *." (R. 32656). In its order denying rehearing the Commission offers this reason:

> "[W]e are given discretion as to whether to initiate proceedings * * *. Just as the statute leaves us with discretion as to whether to initiate proceedings we have authority to discontinue proceedings. Regulation under the Natural Gas Act is carried on in the public interest (Section 1(a)), and

there is no obligation to continue these proceedings to the point of making a *definitive finding with respect to Phillips' rates*, where the public interest is not served." (R. 52898) (Emphasis supplied).

The definitive finding the Commission speaks of can only be the statutory requirement of just and reasonable rates.

In *Minneapolis Gas Company v. Federal Power Commission* 294 F.2d 212 (D. C. Cir. 1961), the court below faced the identical issue. There the court said, at page 215:

> "We think the Commission cannot terminate a proceeding after it has actually conducted a hearing to the point of receiving an Examiner's initial decision, without rendering a decision upon the issue presented * * *. [W]e are of the opinion that the Commission, having received all the evidence the parties wish to present, and having before it an Examiner's findings, conclusion and decision, cannot at that point change its mind, wiping out the hearing as though it had never occurred, and in effect decide it will not enter upon a hearing."

The Commission's action in both *Minneapolis Gas* and the instant proceeding resulted in the termination of a proceeding without a decision on the issue presented, which was the justness and reasonableness of rates. Having decided to protect the public interest through the conduct of a proceeding, and having pursued such course through extensive and exhaustive hearings and briefs to the point of initial decision, exceptions, and oral argument, the Commission, in both cases, asserted discretion as to whether to determine the justness and reasonableness of rates. In *Minneapolis Gas* the court found such an assertion unlawful. The majority of the court below refused to make the same judgment in the instant case (App. A, p. 12), while Circuit Judge Fahy, in his dissent, recognized the situations as identical (App. A, p. 20).

An assertion of unlimited discretion to terminate, or abandon, conflicts with Congressional policy. Whenever Congress creates a regulatory agency it uniformly confers broad powers of investi-

gation.[15] These powers are essential parts of the regulatory schemes. *Smith v. Interstate Commerce Commission*, 245 U.S. 33, 46 (1917). For an agency to use any of its powers in a way which conflicts with Congressional policy is unlawful. *Office Employees International Union v. National Labor Relations Board*, 353 U.S. 313, 320 (1957); *Schaffer Transportation Company v. United States*, 355 U.S. 83, 88 (1957).

Certainly it is the intention of Congress that the Commission use Section 5(a) powers to carry out such an investigation as was undertaken in this proceeding. Just as clearly, Congress did not intend that the Commission's power to conduct investigations should be governed by an unlimited discretion to terminate the investigation the moment it reaches "the point of making a definitive finding." (R. 32898).

The law is settled that an agency, such as the Commission, cannot take action without making the finding of fact required by statute. *Mahler v. Eby*, 264 U.S. 32 (1924); *City of Yonkers v. United States*, 320 U.S. 685 (1944). What is particularly serious about the failure to make just and reasonable findings in the instant Section 4(e) and Section 5(a) proceedings is the fact that the termination orders achieve the same result which would have obtained had a finding of just and reasonable been made. By refusing to order refunds the proposed rates became as if just and reasonable rates; by terminating the investigation existing rates remain as if just and reasonable rates.

Finally, Section 8 (b) of the Administrative Procedure Act[16] provides:

> "All decisions * * * shall * * * include a statement of (1) findings and conclusions, as well as reasons or basis therefor, upon all material issues of fact, law, or discretion presented

[15]Examples: Securities Exchange Act (Act of June 6, 1934, c. 404, 48 Stat. 899 (1934), as amended 15 U.S.C. § 780 (1949)); Public Utility Holding Company Act (Act of August 26, 1935, c. 687, 49 Stat. 831 (1935), as amended 15 U.S.C. § 79r (1949)); Federal Power Act (Act of June 10, 1920, c. 285, 49 Stat. 856, 16 U.S.C. § 825 (f) (1935)).

[16]Act of June 11, 1946, c. 324, 60 Stat. 242, 5 U.S.C. § 1007 (b).

on the record; and (2) the appropriate rule, order, sanction, relief, or denial thereof."

The court below and the Commission disregard this requirement.

4. CONSUMER PROTECTION REQUIRES REGULATION, NOT EXPERIMENTATION.

The court below has approved the Commission's promulgation of the Statement of General Policy No. 61-1 (R. 32710-12) whereby the Commission establishes rate levels below which it will not suspend Section 4 (e) increases nor question the rates in new contracts. Such levels will be used until new procedures for the regulation of producers are developed. The court's decision says:

> "[The Commission] has announced guideline rates which it deems to be, on the basis of the internal data in its files on all operators in the several areas, fair rates for the product in those areas. Such rates, thus determined, would seem to be just and reasonable rates for the consumers of the product. And, similarly, they would seem to be just and reasonable charges for the producers to make." (App. A, p. 16).

What the court overlooks is that the rates contained in the Commission's statement were prepared, and can be changed, without notice, hearing, or the taking of evidence. Moreover, the Commission itself does not consider the guideline rates to be necessarily just and reasonable rates:

> "These price levels, as announced by Appendix A attached to this statement, are for the purpose of guidance and initial action by the Commission and their use will not deprive any party of substantive rights or fix the ultimate justness and reasonableness of any rate level." (R. 32712).

Congress intended that just and reasonable rates should be determined in proceedings under Section 4(e) and 5(a). Both provide for hearings.

If the rates contained in the Policy Statement are just and reasonable, as asserted by the court below, then they only prop-

erly may be promulgated after a hearing. Due process demands that the parties to be affected by such rates are entitled to a full and fair hearing. *Morgan v. United States*, 298 U.S. 468 (1936); *Ohio Bell Telephone Company v. Public Utilities Commission of Ohio*, 301 U.S. 292 (1937).

At most, the rates included in the Policy Statement are field, or market, prices for natural gas. In *City of Detroit, Michigan v. Federal Power Commission*, 230 F.2d 810 (D.C. Cir. 1955), cert. denied 352 U.S. 829 (1956), the court below refused to approve a field price as a just and reasonable rate unless the price was tested on a cost of service basis. Therefore, the decision of the court below presents a conflict within the circuit on the issue of field prices.

Section 5 of the Administrative Procedure Act[17] provides that, where a statute calls for an agency hearing, there must be notice and opportunity to be heard. The Commission's own Rules of Practice and Procedure are especially designed to provide for hearings on rate matters. FPC Rules and Regulations, Sec. 1.13-1.26; 18 C.F.R. §§ 1.13-1.26. Accordingly, the Commission's insistence on going its own way, without hearings, in rate matters is unprecedented.

The majority of the court below speaks of the regulation of producers as a "new project." (App. A, p. 12). This Court, when the instant proceeding was first before it, held that Congress intended producer regulation in 1938 when the Natural Gas Act was enacted. Consequently, from June 1938 until this Court's decision in June 1954—a period of sixteen years—there was absolutely no producer regulation. When ordered to regulate, the Commission proceeded with a case by case approach. The Commission's course appeared to be finalized when it said:

> "What [Section 4] does require is the presentation of rate base and cost evidence as a point of departure plus a showing that any additional allowance is no more than is reasonably necessary for the purposes advanced for any increase." *Union Oil Company of California*, 17 FPC 89, 91 (1957).

[17] 60 Stat. 239 (1946); 5 U.S.C. § 1004.

Accordingly, when the instant proceeding commenced, it was assumed by all parties that the Commission would adhere to this course.

Paradoxically, the Commission pursued such course yet refused to follow it to an end. The Commission terminated the rate proceedings and says, in effect, that future producer rate regulation must await the outcome of its area, or commodity, rate proceedings. As a result, the Commission has returned to the same course it followed from 1938 through 1954. The Commission, instead of accepting the Congressional mandate of regulation, adopts a policy of experimentation. The court below recognized that the interim period while new procedures are being formulated may last from "four to fourteen years." (App. A, p. 13). Even this assumes that area rates will be finally approved. In the meantime, there will not be the regulation envisioned by Congress, by this Court, and at one time by the Commission itself.

The question narrows down to one of *experimentation or regulation*. Clearly Congress intended regulation.

Consumer needs are present, not future. Natural gas is a commodity which is being consumed daily and presently by the industry of America and by its people. The clear intent of the Congress in providing for protection against exploitation was present protection, not a deferral to some future providence.

Six years after being ordered to commence regulation of producers, the Commission, upon the threshold of a practical, workable, and legally sound manner of doing so, turns its back upon the process and sets forth into new, uncharted fields and courses, seeking answers unknown presently even unto itself. The answers it seeks, judging by its Policy Statement, are fraught with practical and constitutional difficulties. Most importantly, they apparently require years of searching, exploration, and experimentation which, when added to the time already involved in its efforts, may arrive at a dubious method of regulation fourteen years from the present. Thus consumer interests are in attendance, awaiting answers which may arrive in the year 1974, if they do arrive.

B. The Decision of the Court Below and the Opinion of the Commission Fail to Provide Lawful Regulation of Producers.

1. THE COST OF SERVICE METHOD MUST BE USED UNTIL REPLACED BY ANOTHER LAWFUL METHOD.

The court below agrees with the Commission "beyond any doubt, that the traditional original cost, prudent investment rate base method of regulating utilities is not a sensible, or even workable method of fixing rates of independent producers of natural gas." (App. A, p. 5). Actually, there is much doubt about this statement. As pointed out in the dissent:

> "The Commission has actually found Phillips' cost of service on the basis of the record made and has arrived on the same record at a proper rate of return, stating 'this is clearly a *lawful* way to determine rates for Phillips as illustrated by the *City of Detroit* case, . . . and under the present record is the *only possible method* . . . .' *In this manner the Commission has come so close to doing what it says it should not do as to demonstrate that it is able to do what it has failed to do.*" (App. A, pp. 20-21). (Emphasis supplied).

Cost of service analysis is the conventional approach to rate determination. Referring to rate making under the Natural Gas Act, this Court observed in *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591, 616 (1944):

> "The Committee Report stated that the Act provided 'for regulation along recognized and more or less standardized lines' and that there was 'nothing novel in its provisions.'"

In *City of Detroit, Michigan v. Federal Power Commission*, 230 F. 2d 810, 818 (D.C. Cir. 1955), cert. denied 352 U.S. 829 (1926), the court below, referring to cost of service, states:

> "It has been repeatedly used by the Commission, and repeatedly approved by the courts, as a means of arriving at lawful—'just and reasonable'—rates under the Act. *Unless it is continued to be used at least as a point of departure*, the whole experience under the Act is discarded and no anchor, as it were, is available by which to hold the terms 'just and reasonable' to some recognizable meaning." (Emphasis supplied).

The courts have with consistency fastened upon a showing as to cost. Beginning with the *Hope* case, down to the *City of Detroit* case, and as recently as *Bel Oil Corporation v. Federal Power Commission*, 255 F. 2d 548 (5th Cir. 1958), cert. denied 358 U.S. 804 (1958), *Forest Oil Corporation v. Federal Power Commission*, 263 F. 2d 622 (5th Cir. 1959), and *Episcopal Theological Seminary v. Federal Power Commission*, 269 F. 2d 228 (D.C. Cir. 1959), cert. denied 361 U.S. 895 (1959), the courts have refused to discard the cost test.

Far from being not "sensible" and not "workable", the Commission itself, in a recent opinion, has relied on cost of service to reach a result in a certificate proceeding. *Continental Oil Company*, FPC Opinion No. 351, January 22, 1962.

The majority of the court below lists several grounds for rejecting cost of service in producer rate cases. The court asserts that such method "penalize[s] the efficient or fortunate and reward[s] the inefficient or unfortunate." (App. A, p. 5). Furthermore, " 'extremely difficult' problems of allocating costs are involved." (App. A, p. 5). Finally, there is the problem of the "administrative burden of full rate cases for each of thousands of independent producers." (App. A, p. 6). These grounds are without merit.

First, the court does not say how the so-called efficient, fortunate producer is penalized, what harm is done to him, how he suffers in contrast to a less efficient, unfortunate producer. The court's statement assumes that there is some advantage to be gained by being inefficient and having bad luck. Under cost of service regulation both receive a fair return on investment and one is placed in no better a position than the other. Actually, in our free enterprise system, other business factors, such as quality of service or competence of management, work to penalize the inept and unlucky and to favor the efficient and fortunate.

Second, the examiner's decision provides a sensible and workable formula for the allocation of costs between gas and oil. Neither the Court nor the Commission questions such formula.

Third, the alleged administrative burden of producer rate cases cannot be met by a decision to do nothing. The Commission should apply self-help and expedite its hearings and decisions. The history of producer regulation is one of delay and indecision. Certainly the mandate of Section 4(e) to "decide the same as speedily as possible" is not being followed. The blame properly cannot be placed on the cost of service method.

Since the court below has treated the instant case as one dealing with the rates of natural gas producers generally, it is important that this Court review the rejection of cost of service. By such rejection the Commission has left itself with no known, workable, and approved system to regulate while it experiments with new procedures.

2. SPIRAL ESCALATION CLAUSE INCREASES ARE UNLAWFUL IN A REGULATORY SETTING.

Spiral escalation clauses can best be explained by a description of their operation. These clauses permit increases in the contract price received by a producer from a pipeline company when there is an increase in a price index followed by an increase in the resale rates of the pipeline company. When both these conditions are met, the contract price is increased in proportion to the increase in the resale rates.[18]

In the instant proceeding, Dockets Nos. G-11217, G-10883 and G-10793 are rate increase filings based on the activation, or "triggering", of spiral escalation clauses. The Commission left open Docket Nos. G-11217 and G-10883 only for the resolution of the extent of the increase, and for "no other matter." (R. 32696). They were left open because the resale rates of the pipeline companies had not yet been finally determined. In the third docket, No. G-10793, the rate increase was allowed to become effective. Consequently, in each instance, the Commis-

[18]The Phillips El Paso contracts contain typical spiral escalation clauses. These agreements provide that when the commodity index increases more than a prescribed number of points and a general increase in El Paso's rates is put in effect, then Phillips' rates will be increased in proportion to the increase in El Paso's rates. (R. 31642-43).

sion gives legal effect to the clauses. Yet the court below refuses to review the issue. (App. A, p. 18).

An analysis of the whole scheme of natural gas regulation makes it clear that the elimination of spiral escalation clauses from purchase contracts is essential to the regulation of an industry affected with a public interest. Such clauses permit price increases based on fortuitous events and not regulatory requirements. They allow natural gas prices to soar on the basis of automatic and arbitrary adjustments which have no relationship to increases, if any, in Phillips' costs.

The Commission made it clear that one of the major issues in the proceeding was whether spiral escalation clauses are "so ambiguous in language and so inflationary in effect as to contravene the public interest and conflict with the regulatory powers of the commission, or are otherwise unlawful." (R. 31003). In its opinion the Commission says:

> "While we do not approve of such clauses in principle, there is not sufficient basis on this record to hold them void as a matter of law." (R. 32694).

The court below recognizes the unlawful character of these devices, but errs in holding the question is not ripe for review. The court says:

> "Wisconsin and California contend that the Commission should now declare these escalator clauses to be illegal and void as against public policy. As a matter of fact the Commission has declared these clauses to be against the public interest and that they should be held inoperative. But, the Commission says, in so far as these cases of Phillips are concerned, action of the sort demanded by Wisconsin and California is premature. Action on these clauses, it says, should await action on the pending cases which in orderly processes present the problem for decision. We agree with the Commission." (App. A, p. 18).

The court neglects to note that the Commission overlooks the spiral escalation increase in Docket No. G-10795, unaffected by pending pipeline company litigation, which was approved. The approval in this instance, at least, presents the issue for review.

No record, either in this proceeding or any other proceeding, can justify the presence of these clauses in natural gas contracts. Moreover, the court below and the Commission may not perpetuate the existence of a device which is unlawful.

C. The Decision of the Court Below and the Opinion of the Commission Overlook the National Importance and Significance of This Proceeding.

1. THE IMPORTANCE OF NATURAL GAS REGULATION TO CALIFORNIA CONSUMERS.

California commenced importing natural gas from out-of-state sources in 1947. In 1960 it purchased 804,600,000,000 cu. ft. of gas from El Paso Natural Gas Company (El Paso) at a cost of $252,000,000. The most recent figures show that during the period from November 1960 through October 1961 California purchased from El Paso 774,000,000,000 cu. ft., paying $257,000,000.[19]

The California Public Utilities Commission conservatively estimates that by 1970 California will be importing 1,825,000,000,000 cu. ft. annually and will be paying in excess of $700,000,000.

California's interest in this proceeding stems from its unique dependence upon natural gas as a fuel. Since California does not possess coal deposits sufficient for its energy requirements, it is compelled to rely upon natural gas. Ninety percent of all homes in California are heated by natural gas, and California industry relies almost exclusively upon natural gas as a fuel. California now depends upon El Paso for approximately three-quarters of its needs.

El Paso obtains the gas it sells from various sources, chief among which is Phillips. El Paso purchased 212,946,306,000 cu. ft. from Phillips in 1960. This cost El Paso $31,347,200.[20] El

[19]These statistics are compiled from monthly reports filed with the California Public Utilities Commission by California natural gas public utility distributing companies.

[20]Annual Report of El Paso Natural Gas Company to Federal Power Commission for Year Ending December 31, 1960, FPC Form 2, Gas Purchase Account, pp. 89-90.

Paso's costs are passed on, under the cost of service method, to the California distributing utilities so as to assure El Paso a fair return above its costs. The California utilities, in turn, pass them on to the California consumers.

California consumers, then, have a substantial interest in the regulation of producers such as Phillips. This interest serves to emphasize the importance, and the impact, of the majority's decision to uphold the Commission. This Court should review that decision in the light of this interest for involved here are the regulatory principles which assertedly are to govern not only Phillips' rates, but also the rates of all producers.

2. THE NATIONAL IMPORTANCE AND SIGNIFICANCE OF PRODUCER REGULATION.

The fact that the costs of purchased gas are eventually paid by the consumers points out the national importance and significance of effective regulation of the price of natural gas at its production stage. Producers, such as Phillips, sell gas to pipeline companies, such as El Paso, at wellheads, at field gathering points, or at outlets of processing plants. The prices fixed at these points of sale are crucial in the determination of the prices set by the pipeline companies to the distributing companies, and the prices charged by the latter to the ultimate consumers. Absent producer regulation, the Natural Gas Act would be only a makeshift barricade against a surging river without any attempt to control the river itself. With the decision of the court below and the opinion of the Commission, regulation of the natural gas industry at this focal point of its activity is, in effect, suspended.

During this indefinite period of suspension the nation can expect further decline in the ratio of natural gas reserves at end of year to net production. In 1947 it was estimated that there were 29.5 years of reserves in the United States; in 1960 it was determined that there remained only 20.2 years of reserves.[21]

[21]Source: American Gas Association, Historical Statistics of the Natural Gas Industry.

Moreover, the ratio of annual gross additions to natural gas reserves to net production is also declining. If consumers are to wait as long as fourteen years until a kind of regulation called for by the Natural Gas Act and the courts is resumed, if it is resumed, then there may well be no gas, or very little gas, left to regulate.

Conceding, however, that the life index of the gas reserves may be approximately forty years, as optimistic segments of the industry assert, the nation's consumers are then confronted with the chilling fact that their guardian against exploitation has left them without protection since 1948—a period of twelve years in the life of the gas reserves, or when coupled with an additional fourteen years of experimentation, a total of twenty-six years absent effective regulation.

Time is crucial in this proceeding. Accordingly, the proceeding may best be disposed of, in the national interest, by following the position of Circuit Judge Fahy in his dissent:

> "These cases need not be treated as if they were ventures initiated in search of an ideal method of regulating the rates of independent gas producers. Having in mind the history of these proceedings, and the primary congressional purpose of consumer protection, it seems to me that decisions on the present record, supplemented as may be found to be reasonably necessary, would be far more likely to approximate fulfillment of the purposes of the Act than are the termination order and the resulting situation." (App. A, p. 20).

During this period of suspension, rate increase may be piled upon rate increase without any hearings as to their justness and reasonableness. In an inflationary economy, a time lag in the adjudication of the lawfulness of successively increased rates will work to the harm of the consumer. It will be difficult, if not impossible, for the Commission to adjudicate the reasonableness of rates which have long since been overcome by inflation.

The judicial mandate and the dictates of the Natural Gas Act could be openly defied, but without success, if the Commission were to announce its outright refusal to regulate the production

of natural gas. Petitioners ask whether or not interminable administrative proceedings—apparently seeking an ideal and perfect method of doing things and always at great length and consuming long periods of time—are not presently or, at least, will not soon be tantamount to failure to regulate. Certainly it can be said that if this grand experiment, seeking that best of all possible regulatory worlds, continues for another fourteen years, America's needs will be less than effectively protected, if at all.

CONCLUSION

Petitioners respectfully request the opportunity to present these questions to the Court more fully. They are important questions of public law. Their resolution will have far-reaching effect.

They are questions affecting millions of citizens and involving billions of dollars.

Petitioners respectfully submit that this petition for a writ of certiorari to the United States Court of Appeals for the District of Columbia Circuit should be granted.

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Of Counsel

(Appendices follow)

Appendix A

United States Court of Appeals
For the District of Columbia Circuit

No. 16175

STATE OF WISCONSIN and PUBLIC SERVICE COMMISSION OF WISCONSIN, PETITIONERS

v.

FEDERAL POWER COMMISSION, RESPONDENT
PHILLIPS PETROLEUM COMPANY, INTERVENOR

No. 16177

LONG ISLAND LIGHTING COMPANY, et al., PETITIONERS

v.

FEDERAL POWER COMMISSION, RESPONDENT
PHILLIPS PETROLEUM COMPANY,
PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK, INTERVENORS

No. 16180

PEOPLE OF THE STATE OF CALIFORNIA and PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, PETITIONERS

v.

FEDERAL POWER COMMISSION, RESPONDENT
PHILLIPS PETROLEUM COMPANY, INTERVENOR

On Petitions for Review of Order of the Federal Power Commission

Decided November 30, 1961

Mr. William E. Torkelson for petitioners in No. 16175.

Mr. J. David Mann, Jr., with whom *Messrs. John E. Holtzinger, Jr.*, *William W. Ross*, and *David K. Kadane* were on the brief, for petitioners in No. 16177.

Mr. William M. Bennett for petitioners in No. 16180.

Mr. Arthur H. Fribourg, Attorney, Federal Power Commission, with whom *Mr. John C. Mason*, General Counsel, Federal Power Commission, at the time the brief was filed, and now Deputy General Counsel, and *Mr. Howard E. Wahrenbrock*, Solicitor, Federal Power Commission, were on the brief, for respondent.

Mr. Kenneth Heady, of the bar of the Supreme Court of Oklahoma, *pro hac vice*, by special leave of court, with whom *Messrs. Charles E. McGee* and *Lambert McAllister* were on the brief, for intervenor Phillips Petroleum Company.

Messrs. Kent H. Brown and *George H. Kenny* and *Mrs. Barbara M. Suchow* were on the brief for intervenor Public Service Commission of the State of New York in No. 16177.

Before PRETTYMAN, FAHY and DANAHER, *Circuit Judges*.

PRETTYMAN, *Circuit Judge:* Some controversies concern major problems of general application. Others concern only a limited set of circumstances. The case at bar is of the former variety. The questions are posed by complicated procedural difficulties. They concern the procedures of the Federal Power Commission in dealing with the rates of natural gas producers.

The Phillips Petroleum Company is a producer of natural gas. It procures gas from several widely separated and widely differing areas. It explores for, develops, produces, purchases, gathers and processes gas and oil. It sells gas to pipeline companies[1] under contracts negotiated by it and these customers. The

[1] It also sells oil, products condensed from gas, and other petroleum products and chemicals. It sells natural gas in several conditions. It sells to customers other than pipelines as well.

contracts differ in such terms as delivery conditions, water content, hydrocarbon content, place of delivery, pressure, and price.

Two sections of the Natural Gas Act[2] are involved. One (Section 4(e)) provides in essence, as to sales subjected to regulation by the Commission, that when a rate or an increased rate is filed the Commission may suspend it for five months, meantime setting it for hearing. When such a rate goes into effect after the period of suspension (the Commission not having concluded its consideration), the funds derived from the newly-filed rates may be impounded and, in so far as the Commission fails to approve them, may be refunded. The burden of proving in such a proceeding that an increased rate is "just and reasonable" rests upon the company. The other section of the statute (5(a)) provides in essence that, either upon a complaint or upon its own motion the Commission may inquire into an existing rate. If that rate be found unlawful the Commission must determine what shall thereafter be deemed a just and reasonable rate. Its decision becomes effective from its date. No refund is involved.

In October, 1948, the Commission instituted a proceeding under Section 5(a), the latter of the above sections, concerning Phillips's rates. In that proceeding it decided it had no jurisdiction over the rates of producers of natural gas. This court reversed the Commission,[3] and the Supreme Court affirmed our decision.[4] The Commission reinstated its 5(a) proceeding.

Meantime and thereafter Phillips filed increased rates in respect to many of its contracts. The Commission suspended them and set them for hearing, under Section 4(e) of the statute, the first of the two sections above discussed. Many purchasers, many contracts, many rate schedules, and many filings were involved. Thus many 4(e) proceedings, under different docket numbers, were instituted. As time went on, Phillips filed further proposed

[2]52 Stat. 821 (1938), as amended, 15 U.S.C. §§ 717-717w.

[3]State of Wisconsin v. Federal Power Comm'n, 92 U.S. App. D.C. 284, 205 F.2d 706 (1953).

[4]Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954).

increases in some of these same rates. In such event the earlier proposed rate would, if approved, cover a limited period, *i.e.*, until the succeeding increase in that same contract rate was filed. A period thus limited is called a "locked-in period" in the jargon of the industry. These later increases were also suspended by the Commission. Thus many proceedings under Section 4(e) involving rates of Phillips became pending.

The Commission consolidated the 5(a) proceeding and twelve of the 4(e) proceedings for hearing. These twelve 4(e) proceedings involved an aggregate of about five and a half million dollars in proposed increased rates. The proposed rates ranged from 5½ cents per Mcf to 13-½ cents per Mcf. The proceeding was long, detailed, and resulted in a voluminous record of testimony and exhibits. The Examiner rendered a long (174 printed pages), careful and complete initial decision. He approached the problem from the standpoint of cost-of-service[5] and rate base. Many perplexing problems were presented. He examined them all and decided them. Among them were different approaches to cost-of-service, the allocation of production costs, the allocation of exploration costs, the problem of natural gas liquids, the rate base, adjustment to the test year, the computation of the income tax component, the proper rate of return, working capital, allocations between jurisdictional and non-jurisdictional sales, field prices, a discussion of system-wide as compared with area rates. Upon all these the Examiner made detailed findings and conclusions, displaying commendable patience and grasp of the subject matter. He adopted a system-wide approach and found that Phillips's total jurisdictional cost of service, properly computed, was $57,280,218 for the test year,[6] or an average unit cost of 11.662 cents per Mcf. He recommended that Phillips be ordered to calculate a maximum rate for gas with certain described qualities at such level that, when applied to the sales volume

[5]Cost-of-service in this context includes not only operating expenses, taxes, exploration allowances, and gas purchases but also a fair return on the rate base.

[6]Compared with 92.3 million dollars claimed by Phillips.

for all jurisdictional contracts, adjusted for approved delivery condition differentials, would produce revenues roughly equal to the system-wide cost of service. He recommended that Phillips be ordered to file, with full explanations, a list of rates so calculated. These calculated rates would be subject to approval by the Commission. He recommended that the rates thus calculated and approved be applied in both the 4(e) and the 5(a) proceedings, *i.e.*, to both suspended and future rates.

The Commission reversed the Examiner. Its decision and findings were also extended and exhaustive (82 printed pages, plus exhibits). One Commissioner dissented in respect to the computation of the cost of service; otherwise he concurred. Basically, the Commission concluded "beyond any doubt, that the traditional original cost, prudent investment rate based method of regulating utilities is not a sensible, or even a workable method of fixing the rates of independent producers of natural gas." It pointed out critical differences between pipeline operations and producer operations, quoting from opinions by Mr. Justice Harlan and Mr. Justice Jackson, and saying that in regulating producers it is faced with problems entirely different from those of an ordinary public utility. It pointed out that simply to allow producers a return on investment would penalize the efficient or fortunate and reward the inefficient or unfortunate. Only where a producer purchases a fully developed acreage at a fair price does his investment have a real relationship to his return. The producer who first takes the risk in an area and proves it productive pays less for his rights than those who come later. But he must invest his funds before he knows whether he will have anything to sell or not. Mr. Justice Jackson once wrote that "there is little more relation between the investment and the result than in a game of poker."

The Commission pointed out that a producer of natural gas also produces oil, the price of which is unregulated, makes sales (intrastate, etc.) not subject to Commission jurisdiction, and sells products also excluded. Thus "extremely difficult" problems of allocating costs are involved. It commented that none of the ex-

perts proposed allocations acceptable to other experts. "Ridiculous results will be reached among the great number of producers and owners of interests if costs should be the only basis for regulation." It referred to the fact that much of Phillips's gas is purchased from thousands of independent producers whose rates are under percentage-type casinghead contracts, dependent on Phillips's rates. The interests of the many royalty owners must also be considered. Another problem is the administrative burden of full cost rate cases for each of thousands of independent producers. Adherence to cost rate-base methods results in necessity for a full-scale company-wide cost study to determine the proper price in any one contract. At the time of this Commission decision 3372 independent producers had rates on file. Five hundred seventy producers were involved in 3278 proposed rate increases under suspension and awaiting hearing. Of eleven rate increase cases in which full hearings had been had and decisions rendered, ten showed the increases justified. A special problem prevented decision in the other. In the three 5(a) cases theretofore completed, the producers' prices were found justified. Rigid adherence to the rate-base method would in many cases price the producers' gas out of the market. "From the foregoing, it follows that effective regulation of the price of natural gas must be on some more manageable plan than the rate base method. Thus it it clear that the better method would be to establish fair prices for the gas itself and not for each individual producer."

Simultaneously with the foregoing opinion the Commission promulgated a "policy statement" setting forth rate guidance schedules for various producing areas. These schedules consisted of two rates prescribed for each of twenty-three producing areas throughout the country (except for two areas, for which only one rate was given). One rate was for initial service, *i.e.*, new contracts, in the area. The other was for increases in rates, *i.e.*, proposals for increases in existing contracts, in the area. For example, in the first area listed (Texas District No. 1) an initial service rate of 15.0 cents per Mcf was given and an increased

rate level of 14.0 cents per Mcf. The Commission described its preparation of these schedules thus:

> "In arriving at the price levels for the various areas set forth in the appendix to this statement, we have considered all of the relevant facts available to us. Such consideration included cost information from all decided and pending cases, existing and historical price structures, volumes of production, trends in production, price trends in the various areas over a number of years, trends in exploration and development, trends in demands, and the available markets for the gas. Of necessity, we have not set forth the adjustments to these prices which must be made to take into account every possible provision of every contract which may affect the actual price, such as Btu adjustments, conditions of delivery, etc. The relevance of such adjustments to the basic contract price and the appropriate established price standard must be considered as each filing is made."

The proposed use of this list was described by the Commission as follows:

> "* * * These standards will serve as a guide to us and to interested parties in determining whether proposed initial rates should be certificated without a price condition and whether proposed rate changes should be accepted or suspended.
>
> * * * * * * *
>
> "These price levels, as announced by Appendix A attached to this statement, are for the purpose of guidance and initial action by the Commission and their use will not deprive any party of substantive rights or fix the ultimate justness and reasonableness of any rate level."[7]

In its opinion the Commission said further: "This schedule of prices is only for guidance and does not constitute any determination of just and reasonable rates and will not foreclose any person from justifying a particular rate in any area." The schedule is of maximum acceptable rates for gas from a given area.

[7]Statement of General Policy No. 61-1, Sept. 28, 1960, 25 Fed. Reg. 9578 (Oct. 5, 1960).

as opposed to rates established for each rate filing by each producer after a full cost-rate base consideration of each rate so filed.

The Commission disposed of the consolidated cases before it in three parts. The first part consisted of the superseded rates of the prior periods ("locked-in" periods). The second consisted of the presently current rates and those to be in effect during the interim period from now until the newly proposed area-rate system is completely designed and put into effect. The third part consisted of rates for the future after the completion and inauguration of the area-rate system.

Before we consider these several dispositions in detail we must understand the problem with which the Commission was dealing. The rates proposed to be increased in these 4(e) proceedings are not the rates of utilities in the traditional sense, such as pipelines. The rates here involved are the charges made by companies which buy or produce a product, process it to suit the requirements of a customer, and sell it to that customer under a contract. The product is procured from many different places, from Texas to West Virginia, from Louisiana to Wyoming. In its raw state it is of many different contents. Different customers require different terms as to the physical qualities of the delivered article, points and terms of delivery, and other factors. Hundreds of producers, hundreds of contracts, and thousands of rate filings are involved.

When we use the terms "cost of service" or "rate base" in this context, we must be careful of the meaning we intend. There is a system-wide cost of service. This would be, as the words indicate, a computation for the entire Phillips system. But even so it would not be a computation for all Phillips operations, because the Company has many operations, such as those in petrochemical fields, and sales of all sorts of petroleum products, and many sales not subject to federal regulation under present statutes. In fact the Company's gross income from sales of natural gas in 1955 was less than six per cent of its total gross income. So even a system-wide computation of cost of service for sales of natural gas subject to Commission regulation requires monu-

mental allocations of many costs, such as exploration costs, taxes, administration expenses, purchases, extraction costs, sales of residue gas and liquids, and so on. Nevertheless such a computation was made. The Examiner and also the Commission determined and used a system-wide cost of service. As found by the Commission the system-wide cost of service for Phillips's sales of natural gas subject to Commission jurisdiction in the test year 1954 was $55,548,094, or 11.309 cents per Mcf. But even the figure thus carefully computed was subject to adjustment for purchased gas costs, gathering taxes, and royalties. The same observations apply to the rate base on a system-wide basis. One was determined by the Commission.

Then, theoretically at least, there is a cost of service for each contract, if not for each rate, and so for each 1(c) proceeding. But nobody, so far as we are advised, contends that any such computations could be made with any meaningful results by any known method. The results of any such effort would be pure guesswork, involving a vast multiplication of the arbitrary allocations which would have to be made.

The Examiner did not attempt to make any cost-of-service determination on individual contract, rate, or case basis. He determined a system-wide cost of service, which gave him a nation-wide average unit cost of 11.662 cents per Mcf. He then proposed that "[b]ased on the system-wide cost of service herein approved, as set forth in Appendix Table 12 hereof, Phillips shall calculate the maximum rate for 1,000-pound, sweet, dehydrated, and gathered gas at such level that its application to the sales volumes delivered in 1954 under each and every one of the 1954 jurisdictional contracts, as adjusted for the approved delivery condition rate differentials, will produce total revenues roughly equal to such system-wide cost of service." He proposed further that "Phillips shall file with the Commission a statement of such 'maximum rate,' including a clear and detailed explanation as to the manner in which it was calculated, together with a list of *calculated rates* for all of its jurisdictional rate schedules then in effect." The Commission, as we have said, reversed the Examiner, treating the case, in effect, in three parts.

1. As to the first part of the problem, the 4(e) proceedings, dealing with suspended proposals now superseded, the Commission made system-wide conclusions as to jurisdictional sales and applied them to these cases. It found $45,568,291 of revenues against $55,548,054* cost of service. This showed a system-wide deficit of some $9,000,000 on jurisdictional sales of natural gas. The Commission noted that no evidence had been presented to show that the different rates in these different (4(e)) proceedings were unduly discriminatory or preferential, which notation, translated, means that any adjustment in these rates should be correspondingly proportionate in respect to each and all. The Commission applied the result of its system-wide calculations to each and all of the 4(e) proceedings and concluded that no refunds were due. Having thus ordered, it concluded ("terminated") the proceedings.

The Commission made no determination of the cost of service of each of these contract rates separately; it had no evidence before it upon which it could make such determinations, and it was of opinion that such computations would be unworkable and foolish under the circumstances.

In these 4(e) cases, as we have pointed out, the Commission was dealing with a locked-in period. The revenues derived from the rates at issue had been impounded. The only question of substance in respect to that period was whether refunds should be made. The Commission decided that question, flatly and directly. No other question remained in those cases for decision. They presented no questions as to rates to be charged. Each presented the question whether a refund was due that customer for that past period and, if so, how much. Having made three determinations—(1) that there was a deficit of some $9,000,000 a year in revenues against cost of service, (2) that the increases involved totaled about five and a half million dollars and so, if allowed in full, would not wipe out the operating deficit, and (3) that any adjustments should be proportionate to all contract rates—

*Modified to $54,525,315 after rehearing.

it concluded that no refund was due on any contract, &c., in any 4(e) proceeding. Section 4(e) pertinently says that the Commission may 'order a refund of the portion of such increased rates or charges by its decision found not justified.' We cannot say that a deficit justifies or requires a refund or that the Commission was unlawfully arbitrary in reaching that result from the premises.

We think the Commission's course was reasonable and tenable. Surely, if only a single rate had been involved, and enough evidence were introduced to justify, under testing, a conclusion that the company was operating at a deficit under that rate, it would not be necessary that evidence be taken to establish the precise penny amount of the deficit in order to support a reasonable inference by the Commission that no refund was indicated. Of course, in the matter at bar a number of rates in separate cases were involved, but the principle of procedure and the scope of permissible inferences from basic facts are much the same as in the suggested illustration. We think the facts support the conclusion.

It is argued that the Commission did not declare the rates under consideration to be just and reasonable or the contrary; that, instead, it 'terminated' the proceeding. The contention is that the Commission made no decision. We think the point is not well taken. The Commission did make a clear decision, after elaborate findings, upon the one substantive issue before it. It did say it 'terminated' the proceedings, but it terminated them after decision, the basic and dispositive issue, and it entered an order on that decision. Its 'termination' was much like that of a judge after he has rendered findings, conclusion and judgment.

Whether the Commission should have preceded its ultimate conclusion of no-refund with an intermediate conclusion of justness and reasonableness in the rates at issue, and whether it properly added the termination order to its decisive finding, seem to us to be immaterial queries. The important feature is that the Commission reached and decided the critical substantial issue, rationally and upon detailed findings of basic facts upon an ample record.

This is not a *Minneapolis Gas*[9] situation, in which the Commission did nothing but simply terminated the proceeding without passing upon any of the disputed issues before it.

2. The case yields to clearer treatment if we next consider the part of the Commission's treatment which is last in chronological order, that is, the determination of rates for the future. As to these rates the Commission embarked upon the formulation of a new method of fixing just and reasonable rates for producers. It inaugurated hearings for that purpose. We think we need not explore the possibilities of success in that venture, or stop here to describe the projected scheme previously outlined in this opinion. In general it is referred to as an area-price method; it aims to establish proper prices for the gas rather than for the seller thereof. The Congress has confided the regulation of the natural gas industry to the Commission, not to the courts. The Supreme Court has said several times that the Commission is not bound to any one method or to known methods. The regulation of gas producers is a new project. Obviously, as is cogently pointed out in this record, it presents new and complex facts and problems. It would be foolish for the courts to hold that the Commission is bound to apply to these new conditions the methods and measurements designed and used for other and different regulatory purposes. We think it is clear that the Commission had ample authority to embark upon an effort to design suitable new standards for use in the regulation of producers when it found that the tools at hand were not suited to this purpose. The Commission abandoned the pending 5(a) proceeding in which it had been endeavoring to establish rates for the future by methods it now deems inadequate. We see no reason why it should not have done so.

3. The difficult part of the case before us concerns the second, or middle, part of the Commission's disposition. This involves the rates for the period from 1959 until the new system—or a

[9]Minneapolis Gas Company v. Federal Power Commission, U.S. App. D.C. , 294 F.2d 212 (D.C.Cir. 1961).

new system is designed and established. This period will be long, estimates running from four to fourteen years. The rates during this period may, theoretically, be (1) rates in effect without increases having been proposed after January 1, 1959, (2) rates proposed to be increased since that date and suspended under Section 4(e), (3) rates for which increases may be proposed after the present time, (4) initial rates, *i.e.*, rates under new contracts made after January 1, 1959.

To meet the need for interim regulation the Commission took several steps. It published the policy statement which we have described. That announcement contained several components. First, the Commission said that in determining its own *sua sponte* action in respect to rates (*i.e.*, suspending proposed increases or inaugurating inquiries into existing rates) it would be guided by the guide rates. Second, it said that persons attacking rates (*i.e.*, customers and consumers) would be required to present evidence as to the industry generally in the area concerned, as well as the traditional evidence relating to the individual producer involved. Third, it said that "[a]s experience and changing factors may indicate," it would change the areas designated and likewise change the guide prices. Fifth, it said it will use its guide rates in disposing of 4(e) (*i.e.*, suspended proposed increases) proceedings arising upon increases proposed since January 1, 1959.

Refraining from exploring the various arguments, and argumentative trails, pointed out to us by the parties, we come directly to the crux of this problem. Has the Commission power under the Natural Gas Act to do what it did? Can it adopt upon the basis of its own expertise and its files, without a record made in the open in respect to the specific subject matter in issue, and without hearing, a set of guide lines by which it will be controlled in its regulatory functions during an interim period while it is attempting to perfect a suitable system for permanent regulation? We think it can.

In the first place, and throughout, we must remember that the Congress has power to direct the regulation of interstate commerce, and it has placed that regulatory power over natural gas

in the Power Commission. We must remember that the problem at bar concerns a regulatory power. We are not considering adjudicatory, or quasi-judicial, power. It has long since been established that rate-making is a legislative function, and it is so defined in the Administrative Procedure Act.

Regulation poses many difficult problems. New regulation poses acutely difficult problems. Solutions often-times develop slowly. Many illustrations of that fact could be called to mind.

What power has the Commission in respect to interim regulation while the permanent structure is being designed and erected? Must it use means and methods long established for use in respect to other and different regulatory necessities? Or may it design from its own judgment and accumulated data a new method designed for the new problem? The differences between a public utility, such as a pipeline rendering a service by means of a fixed plant and operation, and a producer, who discovers or buys a product where, when and under such terms as he may, and sells that product under contracts negotiated on the open market, are too evident to justify elaboration. Whether the method thus designed and put into use by the Commission is good or bad is no part of our problem. Our inquiry is whether it was within the orbit of statutory authority and whether it was within constitutional limitations. We turn to those questions.

The Natural Gas Act is broad in its bestowal of power. It declares that all rates demanded by a company in connection with the sale of gas in interstate commerce for resale shall be just and reasonable. Section 4(a). A gas company files with the Commission schedules of its rates. Section 4(c). If a company proposes to increase a rate, it must file a new schedule. The Commission may then enter upon a hearing concerning the "lawfulness" of the proposed rate. Section 4(e). If the Commission, on its own motion or upon complaint, finds a rate unjust, unreasonable, unduly discriminatory or preferential, the Commission "shall" determine the just and reasonable rate. Section 5(a). Of course, constitutional restrictions apply; rates fixed by governmental authority cannot be confiscatory; all procedures must be

by due process, that term conveying meanings differing according to the basic nature of the proceeding but always including that which is fair and decent according to the standards of our social order and time.

The statute contains no definition of a "just and reasonable" rate. It is established by tradition and by many court decisions that for a public utility rendering service by use of fixed equipment, a just and reasonable rate is one which returns a fair profit upon the investment, or which supplies the utility with adequate revenues to command needed funds upon an economically reasonable basis. But what of a fair price for a commodity bought and sold by a merchandiser? Almost the whole of the economics of merchandizing differs from the economics of public utility service. Are the just and reasonable prices of such a merchandiser limited to fair returns on his own investment and prices paid by him (and if so, what investment and what prices), or are those prices reasonably measured by the fair prices for the product as measured by the open competitive market for the product, evaluated by Commission expertise and data on the whole of the market operation? Either criterion is a method of regulation. It seems to us that the choice must lie with the Commission.

Let us emphasize that we do not have before us at this time the question whether any rate set by the Commission as a guide rate falls within the area of reasonable computation. That question is emphatically left open by the Commission, and by us, for consideration when some one or more of the selected guide rates is attacked by a producer, a customer, or a consumer. The problem here at this time is merely whether the Commission may embark upon this method of regulation. Since it is the Commission's judgment that this method is best suited for the regulation of these prices, for the determination of their justness and reasonableness, we find in the statute nothing to deny a trial of the method.

Of course, conceivably, justness and reasonableness from the standpoint of the consumer might be defined as limiting the

vendor's return to a fair amount on his investment, and his price accordingly. But, if the government agency charged with the responsibility in the public interest finds, after elaborate accumulation of data, that such a measurement is unworkable, may not a fair price for the product reflected on the open market, after scrutiny and adjustment by the government agency concerning the factors which produced that price, be just and reasonable for the consumer? Of course the agency would be required to be alert for artificial impulses in such a fair area price, and the avenues of attack by consumers would have to be kept open without obstruction; but, if the latter is avowed, how could we assume in advance that the agency would not protect the consumer as it is charged by the Congress to do? The Commission is not here proposing to accept a field price, or any other price as is. It has announced guideline rates which it deems to be, on the basis of the internal data in its files on all the operators in the several areas, fair rates for the product in those areas. Such rates, thus determined, would seem to be just and reasonable rates for the consumers of the product. And, similarly, they would seem to be just and reasonable charges for the producers to make.

As to the constitutional question of confiscation, it would seem to us that the question should await the proof presented by a producer in respect to a particular rate in a particular area.

Thus we come to conclude that the interim method of regulation proposed by the Commission does not appear at this point in the process to be violative of either statutory or constitutional limitations.

It is urged upon us that the Commission has abandoned regulation of these rates for this interim period. We do not agree with that view. It has certainly changed the method of regulation, or, more precisely, the standards by which it will apply its regulatory power. It has abandoned case-by-case, contract-by-contract measurements on a cost-of-service rate-base basis. It has installed an area fair price measurement for the prices of the product to be sold. In so doing it has abandoned a method it finds to be unworkable and foolish in favor of a method it deems to be

workable and just and reasonable. If that be so, instead of abandoning regulation it is making regulation effective. The choice it faced, at least in its own view, was not between regulation or no regulation but was between effective and ineffective regulation.

If, as some consumer interests fear, the new process turns out to be ineffective in the protection of their interests, the way is open for them to challenge the results; as we have pointed out, that way must be kept open. New rates and increases in rates proposed during this interim will be subject to suspension and refund, and so the rights of customers will be fully protected. The new method will also apply in 5(a) proceedings to any existing rate found to be unjust or unreasonable. Refunds cannot be ordered in the latter cases and so consumers bear the disputed rates during the period of the inquiry. But this same situation obtains in the present process of regulation; the application of the new criteria makes no change in this procedural aspect. In the case at bar the Commission has found, after elaborate consideration, that present rates result in deficits to the Company. Consumers have no tenable ground for complaint of such rates. So it seems to us that the interests of consumers are amply protected during this interim period; at least a contrary effect should await the event for us to disturb the view of the Commission, based as it is upon this record.

There remains for discussion a point concerning two 4(e) proceedings which were not terminated. They involved proposed increases based upon escalator clauses in two of Phillips's contracts. These contracts were made before producers such as Phillips were subject to regulation. They were with pipeline companies, as customers, which were subject to regulation. The contracts provided that, if the pipeline companies were granted increases in the rates they could charge, Phillips in turn would receive increases in the rates it charged these customers. These customers had proposed increases, and they were pending in 4(e) proceedings. The Commission ordered that upon decisions in the customers' rate cases Phillips's cases would be acted upon.

Wisconsin and California contend that the Commission should now declare these escalator clauses to be illegal and void as against public policy. As a matter of fact the Commission has declared these clauses to be against the public interest and that they should be held inoperative. But, the Commission says, in so far as these cases of Phillips are concerned, action of the sort demanded by Wisconsin and California is premature. Action on these clauses, it says, should await action on the pending cases which in orderly processes present the problem for decision. We agree with the Commission.

Affirmed.

FAHY, *Circuit Judge, dissenting, with partial concurrence:* I am not able to agree that the order of the Commission terminating the section 4(e)[1] and section 5(a)[2] proceedings should be affirmed. I think the cases should be remanded to the Commission for decision.

While the Commission advances strong reasons for abandoning cost of service as a method of determining the justness and reasonableness of the rates of independent producers of gas, a careful reading of the Commission's opinion demonstrates that the Commission's conclusion that such a method is unworkable follows from a generalized view of the problem of producer rates rather than from the inability of the Commission to utilize the cost of service method in these Phillips cases.

Embarkation upon the area method preferred by the Commission does not necessitate judicial intervention, certainly not at this time; for judicial review must await a Commission order based upon that method. We should not seek to deter the Commission from pursuing such a method in future proceedings, or from using it in any proceedings already initiated along those lines. But it does not follow in my opinion that the Commission should be affirmed in failing to decide the present cases, though it may need to update the record. In the same breath as it were

[1] 52 STAT. 822 (1938), 15 U.S.C. § 717c (1958).

[2] 52 STAT. 823 (1938), 15 U.S.C. § 717d (1958).

in which it describes the unworkability of the cost of service method the Commission itself accepts that precise method in finding that no refunds are to be required in the section 4(e) proceedings, stating:

> While we have found that the rate base method is not an effective means of regulating the producers' prices, evidence in this proceeding was presented almost entirely upon the cost basis and, of course, there were no ceiling prices issued by us at the time of the hearing. There was some field price evidence introduced, but if field prices could be employed in arriving at rates for Phillips, the evidence was incomplete and unrepresentative of Phillips' diverse sales. Therefore we shall proceed on the basis of the evidence adduced in this case to reach conclusions, as reasonable, intelligent and logical as possible even though we know and have herein stated the difficulties inherent in determining a cost of service for Phillips using the rate method. This is clearly a lawful way to determine rates for Phillips as illustrated by the *City of Detroit* case,[11] and under the present record is the only possible method, and therefore we shall make every effort to reach a result by this means.

The Commission could as well have proceeded, with supplemental data, to decide the question of justness and reasonableness of the rates in the section 4(e) proceedings, and, also, to have determined under section 5(a) the just and reasonable rates to be thereafter observed and enforced.

This view is strongly fortified by the able decision of the Presiding Examiner. After an illuminating analysis of the voluminous record made on a cost of service basis he was able to propose definitive decisions. The record had been made with the cooperation of all parties, Phillips itself affirmatively acquiescing in the position that cost of service was the appropriate basis on which to proceed. Phillips' position, as the Examiner points out, was that its jurisdictional rates should be determined upon the basis of an overall cost of service.

[11] *City of Detroit v. F.P.C.*, 230 F. 2d 810 (CADC), *certiorari* denied, 352 U.S. 829.

It is one thing to say, as the Commission does, that the area method should hereafter be adopted, or even adopted in other cases which have not proceeded as far as those before us. It is quite another thing to say that the latter should not be decided under the standards of the Act because the area method was not used in preparing the record. Unless decided Phillips' challenged rates are left undetermined under the standards of the Act since 1948, and apparently will continue to remain undetermined until some future day when new proceedings, now in an inchoate status with no end in sight, are concluded. Difficult and complicated as the tasks of the Commission admittedly are I cannot agree after reading the Examiner's decision or the Commission's findings that the congressional mandate of section 4(e), which requires that these matters shall be decided "as speedily as possible," is being complied with, or that the responsibilities of the Commission under the Act are discharged in the situation resulting from the termination order.

These cases need not be treated as if they were ventures initiated in search of an ideal method of regulating the rates of independent gas producers. Having in mind the history of these proceedings, and the primary congressional purpose of consumer protection, it seems to me that decisions on the present record, supplemented as may be found to be reasonably necessary, would be far more likely to approximate fulfillment of the purposes of the Act than are the termination order and the resulting situation.

The Commission says it has a discretion to terminate as well as to initiate; but once it has exercised its discretion to initiate and has pursued the matter to the extent we find here its discretion to terminate is not as broad as was its discretion to initiate. The former becomes limited by the conditions existing at the time of its exercise. *Minneapolis Gas Co. v. Federal Power Comm'n*, ... U.S. App. D.C. ....., 294 F.2d 212. Compare *Eastern Air Lines, Inc. v. Civil Aeronautics Board*, ... U.S. App. D.C. ....., 294 F.2d 235.

The Commission has actually found Phillips' cost of service on the basis of the record made and has arrived on the same record

at a proper rate of return, stating "this is clearly a lawful way to determine rates for Phillips as illustrated by the *City of Detroit* case, . . . and under the present record is the only possible method . . . ." In this manner the Commission has come so close to doing what it says it should not do as to demonstrate that it is able to do what it has failed to do.

The finding of the Commission in the section 4(e) proceedings that there could be no refunds because the cost of service exceeded the revenues on the basis of the data for the 1954 test year, I think does not justify the order terminating all but two of the section 4(e) proceedings, or the Commission's invitation to Phillips to move to terminate all others which are still pending. The absence of a decision on the issue of justness and reasonableness of rates has the effect of leaving all rates subsequent to 1954 untested under the standards of the Act. Substance is not achieved merely by finding whether or not refunds were due on the basis of the 1954 data. A finding in that regard should not be independent of a finding of the just and reasonable rates. The former should follow from the fact that the just and reasonable rates are not exceeded by those in effect.

The decision of these cases under the standards of the Act not only would not preclude the Commission from embarking upon the area method, but it also would not preclude the Commission from correcting or modifying the decision should the area proceeding show such correction or modification to be desirable; nor do I think a decision on the present record, supplemented as may be needed, would preclude the Commission, pending conclusion of an area proceeding, from establishing guides, formulated, however, with the aid of a decision in the present proceedings.

I agree with Judge Prettyman as to the prematurity of the request for action on two section 4(e) proceedings which have not been terminated.

Appendix B

Administrative Procedure Act, Act of June 11, 1946, c. 324:

SEC. 5. In every case of adjudication required by statute to be determined on the record after opportunity for an agency hearing, except to the extent that there is involved (1) any matter subject to a subsequent trial of the law and the facts de novo in any court; (2) the selection or tenure of an officer or employee of the United States other than examiners appointed pursuant to section 1010 of this title; (3) proceedings in which decisions rest solely on inspections, tests, or elections; (4) the conduct of military, naval, or foreign affairs functions; (5) cases in which an agency is acting as an agent for a court; and (6) the certification of employee representatives.

* * * * * * *

(b) The agency shall afford all interested parties opportunity for (1) the submission and consideration of facts, arguments, offers of settlement, or proposals of adjustment where time, the nature of the proceeding, and the public interest permit, and (2) to the extent that the parties are unable so to determine any controversy by consent, hearing, and decision upon notice and in conformity with sections 1006 and 1007 of this title. [60 Stat. 239; 5 U.S.C. § 1004].

SEC. 8(b). Prior to each recommended, initial, or tentative decision, or decision upon agency review of the decision of subordinate officers the parties shall be afforded a reasonable opportunity to submit for the consideration of the officers participating in such decisions (1) proposed findings and conclusions, or (2) exceptions to the decisions or recommended decisions of subordinate officers or to tentative agency decisions, and (3) supporting reasons for such exceptions or proposed findings or conclusions. The record shall show the ruling upon each such finding, conclusion, or exception presented. All decisions (including initial, recommended, or tentative decisions) shall become part of the record and include a statement of (1) findings and conclu-

sions, as well as the reasons or basis therefor, upon all the material issues of fact, law, or discretion presented on the record; and (2) the appropriate rule, order, sanction, relief, or denial thereof. [60 Stat. 242; 5 U.S.C. § 1007(b)]

Natural Gas Act, Act of June 21, 1938, c. 556:

SEC. 1. (a) As disclosed in reports of the Federal Trade Commission made pursuant to Senate Resolution 83 (Seventieth Congress, first session) and other reports made pursuant to the authority of Congress, it is hereby declared that the business of transporting and selling natural gas for ultimate distribution to the public is affected with a public interest, and that Federal regulation in matters relating to the transportation of natural gas and the sale thereof in interstate and foreign commerce is necessary in the public interest. [52 Stat. 821 (1938); 15 U. S. C. § 717 (a)]

SEC. 4. (a) All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.

(b) No natural-gas company shall, with respect to any transportation or sale of natural gas subject to the jurisdiction of the Commission, (1) make or grant any undue preference or advantage to any person or subject any person to any undue prejudice or disadvantage, or (2) maintain any unreasonable difference in rates, charges, service, facilities, or in any other respect, either as between localities or as between classes of service.

(c) Under such rules and regulations as the Commission may prescribe, every natural-gas company shall file with the Commission, within such time (not less than sixty days from the date this act takes effect) and in such form as the Commission may desig-

nate, and shall keep open in convenient form and place for public inspection, schedules showing all rates and charges for any transportation or sale subject to the jurisdiction of the Commission, and the classifications, practices, and regulations affecting such rates and charges, together with all contracts which in any manner affect or relate to such rates, charges, classifications, and services.

(d) Unless the Commission otherwise orders, no change shall be made by any natural-gas company in any such rate, charge, classification, or service, or in any rule, regulations, or contract relating thereto, except after thirty days' notice to the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. The Commission, for good cause shown, may allow changes to take effect without requiring the thirty days' notice herein provided for by an order specifying the changes so to be made and the time when they shall take effect and the manner in which they shall be filed and published.

(e) Whenever any such new schedule is filed the Commission shall have authority, either upon complaint of any State, municipality, or State commission, or upon its own initiative without complaint, at once, and if it so orders, without answer or formal pleading by the natural-gas company, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the natural-gas company affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect: *Provided*, That the Commission shall not have authority to suspend the rate, charge, classification, or service for the sale of natural gas for resale for industrial use only; and after full

hearings, either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made at the expiration of the suspension period, on motion of the natural-gas company making the filing, the proposed change of rate, charge, classification, or service shall go into effect. Where increased rates or charges are thus made effective, the Commission may, by order, require the natural-gas company to furnish a bond, to be approved by the Commission, to refund any amounts ordered by the Commission, to keep accurate accounts in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts were paid, and, upon completion of the hearing and decision, to order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the natural-gas company, and the Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible. [52 Stat. 822 (1938); 15 U.S.C. § 717c]

SEC. 5. (a) Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: *Provided, however,* That the Commission shall have no power to order any increase in any

rate contained in the currently effective schedule of such natural-gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural-gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates.

(b) The Commission upon its own motion, or upon the request of any State commission, whenever it can do so without prejudice to the efficient and proper conduct of its affairs, may investigate and determine the cost of the production or transportation of natural gas by a natural-gas company in cases where the Commission has no authority to establish a rate governing the transportation or sale of such natural gas. [52 Stat. 823 (1938); 15 U. S. C. § 717d]

SEC. 19. (b) Any party to a proceeding under this act aggrieved by an order issued by the Commission in such proceeding may obtain a review of such order in the circuit court of appeals of the United States for any circuit wherein the natural-gas company to which the order relates is located or has its principal place of business, or in the United States Court of Appeals for the District of Columbia, by filing in such court, within sixty days after the order of the Commission upon the application for rehearing, a written petition praying that the order of the Commission be modified or set aside in whole or in part. A copy of such petition shall forthwith be transmitted by the clerk of the court to any member of the Commission and thereupon the Commission shall file with the court the record upon which the order complained of was entered, as provided in section 2112 of title 28, United States Code. Upon the filing of such petition such court shall have jurisdiction, which upon the filing of the record with it shall be exclusive, to affirm, modify, or set aside such order in whole or in part. No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission in the application for rehearing unless there is reasonable ground for failure so to do. The finding of the Commission as to the facts, if supported by substantial evidence, shall

be conclusive. If any party shall apply to the court for leave to adduce additional evidence and shall show to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence in the proceedings before the Commission, the court may order such additional evidence to be taken before the Commission and to be adduced upon the hearing in such manner and upon such terms and conditions as to the court may seem proper. The Commission may modify its findings as to the facts by reason of the additional evidence so taken, and it shall file with the court such modified or new findings, which if supported by substantial evidence, shall be conclusive, and its recommendation, if any, for the modification or setting aside of the original order. The judgment and decree of the court, affirming, modifying, or setting aside, in whole or in part, any such order of the Commission, shall be final, subject to review by the Supreme Court of the United States upon certiorari or certification as provided in [former] sections 239 and 240 of the Judicial Code, as amended (U.S.C., title 28, sec. 1254). [52 Stat. 831 (1938), as amended 15 U.S.C. § 717r (b) (1958)]

PETITION FOR A WRIT OF CERTIORARI

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IN THE

Supreme Court of the United States

OCTOBER TERM 1961

No. [redacted] 74

LONG ISLAND LIGHTING COMPANY,
PHILADELPHIA ELECTRIC COMPANY, and
THE UNITED GAS IMPROVEMENT COMPANY, *Petitioners*,

v.

FEDERAL POWER COMMISSION, *Respondent*.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

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February 28, 1962

PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

IN THE

Supreme Court of the United States

OCTOBER TERM 1961

No.

LONG ISLAND LIGHTING COMPANY,
PHILADELPHIA ELECTRIC COMPANY, and
THE UNITED GAS IMPROVEMENT COMPANY, *Petitioners*,

v.

FEDERAL POWER COMMISSION, *Respondent*.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

Petitioners, Long Island Lighting Company, Philadelphia Electric Company, and The United Gas Improvement Company, pray that a writ of certiorari issue to review the judgment of United States Court of Appeals for the District of Columbia Circuit, entered in the above-entitled cause on November 30, 1961.

OPINIONS BELOW

The opinion of the Court of Appeals (App. A, *infra*, pp. 1a-23a) is not yet reported. The opinion and order of the Federal Power Commission (R. 251-342) are reported at 24 F.P.C. 537, and the Commission's order denying rehearing (R. 395-404) is reported at 24 F.P.C. 1008. The decision of the presiding examiner (R. 35-217) is reported at 24 F.P.C. 590.

JURISDICTION

The judgment of the Court of Appeals affirming the Commission's orders was entered on November 30, 1961 (App. B, *infra*, p. 24a). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1) and § 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

QUESTION PRESENTED

The question is whether the Federal Power Commission, for reasons of administrative convenience, may indefinitely defer fixing just and reasonable rates for natural-gas producer sales in accordance with proven and established procedures under Sections 4 and 5 of the Natural Gas Act, because it has chosen to embark upon an entirely new, unformulated and judicially untested method of producer rate regulation, when such indefinite deferral will cause massive and irreparable injury to the consuming public.

STATUTE INVOLVED

The pertinent provisions of the Natural Gas Act, 52 Stat. 821, as amended, 15 U.S.C. 717-717w, are set out in Appendix C, *infra*, pp. 25a-28a.

STATEMENT [1]

Petitioners are engaged in the distribution of natural gas to some 1,300,000 customers in the New York and Philadelphia metropolitan areas. Petitioners obtain their natural gas requirements from certain interstate gas pipeline companies, which in turn purchase, either directly or indirectly, the major part of their natural gas supplies from independent natural gas producers, including Phillips Petroleum Company. Accordingly, the rates charged by Phillips and other independent producers directly affect petitioners' gas costs and the rates which they must charge the ultimate domestic consumer.

When the Federal Power Commission reinstituted the general investigation of Phillips' rates pursuant to the mandate of this Court in *Phillips Petroleum Company* v. *Wisconsin*, 347 U.S. 672, petitioners herein were permitted to intervene in the proceedings and participated actively in all phases. Petitioners presented testimony and other evidence bearing on the appropriate methods for determining Phillips' costs. The regulatory methods sponsored by petitioners were adopted in large part by the Examiner and the Commission in determining Phillips' ~~part by the Examiner and the Commission in determining Phillips'~~ 1954 costs in its decision here (R. 90, 94).

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[1] Petitioners have been permitted to read the petition for a writ of certiorari seeking to review the judgment of the court below filed concurrently herewith by petitioners State of Wisconsin, Public Service Commission of Wisconsin, and Public Service Commission of the State of New York (hereafter Wisconsin-New York petition). Petitioners are in full agreement with the statement appearing at pages 3-10 of that petition, and to avoid burdening the Court with repetitious matter, they would hereby incorporate and adopt that statement in this petition, as though fully set out herein.

When the Commission in its opinion herein (R. 251, 323-329) determined not to fix Phillips' just and reasonable rates, for past and future periods, on this record (augmented if necessary) and terminated the proceedings, petitioners, together with the States of Wisconsin, New York and California, sought review in the Court of Appeals. That court, Judge Fahy dissenting, while emphasizing the major importance of the question, sustained the Commission's action abandoning, for an indefinite period, any effort to regulate the rates of Phillips, as well as other major independent gas producers, under Sections 4 and 5(a) of the Natural Gas Act.

This petition followed.

REASONS FOR GRANTING THE WRIT

The court below has affirmed a conscious decision by the Federal Power Commission to defer for an indefinite period—as the court states, possibly as long as 14 years—regulation of independent producers under Sections 4 and 5(a) of the Natural Gas Act (App. C, *infra*, pp. 25a-28a). The court's reasons are twofold (App. A, *infra*, pp. 14a-19a): first, that the Commission's current administrative difficulties make mandatory such a moratorium on regulation; and second, that the Commission will be able to provide interim protection to consumers against exorbitant gas field prices by applying the untested price levels in its Statement of General Policy 61-1, which are themselves, as Dean Landis has noted, "approximately [the] current maximum prices, which have more than doubled in the past five years."[2]

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[2] Landis, Report on Regulatory Agencies to the President-elect, p. 55, 1960. See Wisconsin-New York petition, Appendix D.

The Commission, however, has repeatedly disavowed either the intention or ability to utilize current maximum and wholly untested field prices in order to set *just and reasonable* rates for independent producers during the interim period, pending development of an area approach to regulation (R. 346; Wisconsin-New York petition, pp. 14-15). The decision below is thus grounded on a basic misconception as to the Commission's ability to protect users of natural gas, in the event the Commission is permitted to abandon its existing and well-advanced regulatory program for testing major producer rates under Sections 4 and 5(a) of the Act.

There can be no doubt that consumers will be left unprotected by the Commission's inaction. Gas field prices have more than doubled during the past 10 years and a very substantial volume of jurisdictional gas sales is now being made by producers at untested and inflated price levels with no possibility of refunds or retroactive reduction. (Wisconsin-New York petition, pp. 23-26). Thus, any substantial delay in the testing of these prices means probable consumer loss—an injury compounded each month regulation is deferred (Wisconsin-New York petition, App. C.)

This Court told the Commission in its *Catco* decision (360 U.S. 378) that it could not defer control of sharply increased *initial* field prices under Section 7 of the Natural Gas Act, pending development of a regulatory method under Sections 4 and 5(a) of that Act. The Commission equally does not have the discretion under *Catco* to delay indefinitely that regulation under Sections 4 and 5(a) when such delay could result in serious consumer injury.

Petitioners are not oblivious to the Commission's administrative difficulties, and have endeavored to cooperate in developing an effective method of producer regulation in the pending and projected area rate proceedings. Petitioners strongly urge, however, that the gas consumers which they serve today are entitled to some protection against virtually unregulated current gas field prices. Granting that protection, as Judge Fahy recognized (App. A, *infra*, 22a-23a), would not cripple the Commission in its search for another method of regulation. It follows that the Commission has exceeded the allowable bounds of its discretion in deciding, for reasons of administrative convenience, to defer effective regulation of existing prices for as much as a decade in the future.

CONCLUSION

There can be no dispute that the question is of major and general importance. The decision conflicts sharply with decisions of this and other Courts of Appeals. It is also demonstrable that delay in clarifying the Commission's regulatory responsibility would only compound the injury to the public which will almost certainly flow from the Commission's abdication of regulatory responsibility. It follows that a resolution of the issue here presented should not be left to a divided Court of Appeals or deferred to future developments.

For the above reasons, as well as the reasons set forth in the Wisconsin-New York petition filed concur-

rently herewith, it is respectfully submitted that this petition for a writ of certiorari should be granted.

Respectfully submitted,

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February 28, 1962

APPENDIX A

UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 16175

STATE OF WISCONSIN AND PUBLIC SERVICE COMMISSION OF WISCONSIN, PETITIONERS

v.

FEDERAL POWER COMMISSION, RESPONDENT
PHILLIPS PETROLEUM COMPANY, INTERVENOR

No. 16177

LONG ISLAND LIGHTING COMPANY, et al., PETITIONERS

v.

FEDERAL POWER COMMISSION, RESPONDENT
PHILLIPS PETROLEUM COMPANY,
PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK, INTERVENORS

No. 16180

PEOPLE OF THE STATE OF CALIFORNIA and PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, PETITIONERS

v.

FEDERAL POWER COMMISSION, RESPONDENT
PHILLIPS PETROLEUM COMPANY, INTERVENOR

On Petitions for Review of Order of the Federal Power Commission

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Decided November 30, 1961

Before PRETTYMAN, FAHY and DANAHER, *Circuit Judges*

PRETTYMAN, *Circuit Judge:* Some controversies concern major problems of general application. Others concern only a limited set of circumstances. The case at bar is of the former variety. The questions are posed by complicated procedural difficulties. They concern the procedures of the Federal Power Commission in dealing with the rates of natural gas producers.

The Phillips Petroleum Company is a producer of natural gas. It procures gas from several widely separated and widely differing areas. It explores for, develops, produces, purchases, gathers and processes gas and oil. It sells gas to pipeline companies [1] under contracts negotiated by it and these customers. The contracts differ in such terms as delivery conditions, water content, hydrocarbon content, place of delivery, pressure, and price.

Two sections of the Natural Gas Act [2] are involved. One (Section 4(e)) provides in essence as to sales subjected to regulation by the Commission, that when a rate or an increased rate is filed the Commission may suspend it for five months, meantime setting it for hearing. When such a rate goes into effect after the period of suspension (the Commission not having concluded its consideration), the funds derived from the newly-filed rates may be impounded

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[1] It also sells oil, products condensed from gas, and other petroleum products and chemicals. It sells natural gas in several conditions. It sells to customers other than pipelines as well.

[2] 52 Stat. 821 (1938), as amended, 15 U.S.C. §§ 717-717w.

and, in so far as the Commission fails to approve them, may be refunded. The burden of proving in such a proceeding that an increased rate is "just and reasonable" rests upon the company. The other section of the statute (5(a)) provides in essence that either upon a complaint or upon its own motion the Commission may inquire into an existing rate. If that rate be found unlawful the Commission must determine what shall thereafter be deemed a just and reasonable rate. Its decision becomes effective from its date. No refund is involved.

In October, 1948, the Commission instituted a proceeding under Section 5(a), the latter of the above sections, concerning Phillips's rates. In that proceeding it decided it had no jurisdiction over the rates of producers of natural gas. This court reversed the Commission,[3] and the Supreme Court affirmed our decision.[4] The Commission reinstated its 5(a) proceeding.

Meantime and thereafter Phillips filed increased rates in respect to many of its contracts. The Commission suspended them and set them for hearing, under Section 4(e) of the statute, the first of the two sections above discussed. Many purchasers, many contracts, many rate schedules, and many filings were involved. Thus many 4(e) proceedings, under different docket numbers, were instituted. As time went on, Phillips filed further proposed increases in some of these same rates. In such event the earlier proposed rate would, if approved, cover a limited period, *i.e.*, until the succeeding increase in that same contract rate was filed. A period thus limited is called a "locked-in period" in the jargon of the industry. These later increases were also suspended by the Commission. Thus many proceedings under Section 4(e) involving rates of Phillips became pending.

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[3] State of Wisconsin v. Federal Power Comm'n, 92 U.S. App. D.C. 284, 205 F.2d 706 (1953).

[4] Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954).

The Commission consolidated the 5(a) proceeding and twelve of the 4(e) proceedings for hearing. These twelve 4(e) proceedings involved an aggregate of about five and a half million dollars in proposed increased rates. The proposed rates ranged from 5¼ cents per Mcf to 13½ cents per Mcf. The proceeding was long, detailed, and resulted in a voluminous record of testimony and exhibits. The Examiner rendered a long (174 printed pages), careful and complete initial decision. He approached the problem from the standpoint of cost-of-service[5] and rate base. Many perplexing problems were presented. He examined them all and decided them. Among them were different approaches to cost-of-service, the allocation of production costs, the allocation of exploration costs, the problem of natural gas liquids, the rate base, adjustment to the test year, the computation of the income tax component, the proper rate of return, working capital, allocations between jurisdictional and non-jurisdictional sales, field prices, a discussion of system-wide as compared with area rates. Upon all these the Examiner made detailed findings and conclusions, displaying commendable patience and grasp of the subject matter. He adopted a system-wide approach and found that Phillips's total jurisdictional cost of service, properly computed, was $57,280,218 for the test year,[6] or an average unit cost of 11.662 cents per Mcf. He recommended that Phillips be ordered to calculate a maximum rate for gas with certain described qualities at such level that, when applied to the sales volume for all jurisdictional contracts, adjusted for approved delivery condition differentials, would produce revenues roughly equal to the system-wide cost of service. He recommended that Phillips be ordered to file, with full

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[5] Cost-of-service in this context includes not only operating expenses, taxes, exploration allowances, and gas purchases but also a fair return on the rate base.

[6] Compared with 92.3 million dollars claimed by Phillips.

explanations, a list of rates so calculated. Those calculated rates would be subject to approval by the Commission. He recommended that the rates thus calculated and approved be applied in both the 4(e) and the 5(a) proceedings, *i.e.* to both suspended and future rates.

The Commission reversed the Examiner. Its decision and findings were also extended and exhaustive (82 printed pages, plus exhibits). One Commissioner dissented in respect to the computation of the cost of service; otherwise he concurred. Basically, the Commission concluded "beyond any doubt, that the traditional original cost, prudent investment rate base method of regulating utilities is not a sensible, or even a workable method of fixing the rates of independent producers of natural gas." It pointed out critical differences between pipeline operations and producer operations, quoting from opinions by Mr. Justice Harlan and Mr. Justice Jackson, and saying that in regulating producers it is faced with problems entirely different from those of an ordinary public utility. It pointed out that simply to allow producers a return on investment would penalize the efficient or fortunate and reward the inefficient or unfortunate. Only where a producer purchases a fully developed acreage at a fair price does his investment have a real relationship to his return. The producer who first takes the risk in an area and proves it productive pays less for his rights than those who come later. But he must invest his funds before he knows whether he will have anything to sell or not. Mr. Justice Jackson once wrote that "there is little more relation between the investment and the result than in a game of poker."

The Commission pointed out that a producer of natural gas also produces oil, the price of which is unregulated, makes sales (intrastate, etc.) not subject to Commission jurisdiction, and sells products also excluded. Thus "extremely difficult" problems of allocating costs are involved.

It commented that none of the experts proposed allocations acceptable to other experts. "Ridiculous results will be reached among the great number of producers and owners of interests if costs should be the only basis for regulation." It referred to the fact that much of Phillips's gas is purchased from thousands of independent producers whose rates are under percentage-type casing-head contracts, dependent on Phillips's rates. The interests of the many royalty owners must also be considered. Another problem is the administrative burden of full cost rate cases for each of thousands of independent producers. Adherence to cost rate-base methods results in necessity for a full-scale company-wide cost study to determine the proper price in any one contract. At the time of this Commission decision 3372 independent producers had rates on file. Five hundred seventy producers were involved in 3278 proposed rate increases under suspension and awaiting hearing. Of eleven rate increase cases in which full hearings had been had and decisions rendered, ten showed the increases justified. A special problem prevented decision in the other. In the three 5(a) cases theretofore completed, the producers' prices were found justified. Rigid adherence to the rate-base method would in many cases price the producers' gas out of the market. "From the foregoing, it follows that effective regulation of the price of natural gas must be on some more manageable plan than the rate base method. Thus it is clear that the better method would be to establish fair prices for the gas itself and not for each individual producer."

Simultaneously with the foregoing opinion the Commission promulgated a "policy statement" setting forth rate guidance schedules for various producing areas. These schedules consisted of two rates prescribed for each of twenty-three producing areas throughout the country (except for two areas, for which only one rate was given). One rate was for initial service, *i.e.*, new contracts, in the area. The other was for increases in rates, *i.e.*, proposals

for increases in existing contracts, in the area. For example, in the first area listed (Texas District No. 1) an initial service rate of 15.0 cents per Mcf was given and an increased rate level of 14.0 cents per Mcf. The Commission described its preparation of these schedules thus:

> "In arriving at the price levels for the various areas set forth in the appendix to this statement, we have considered all of the relevant facts available to us. Such consideration included cost information from all decided and pending cases, existing and historical price structures, volumes of production, trends in production, price trends in the various areas over a number of years, trends in exploration and development, trends in demands, and the available markets for the gas. Of necessity, we have not set forth the adjustments to these prices which must be made to take into account every possible provision of every contract which may affect the actual price, such as Btu adjustments, conditions of delivery, etc. The relevance of such adjustments to the basic contract price and the appropriate established price standard must be considered as each filing is made."

The proposed use of this list was described by the Commission as follows:

> "• • • These standards will serve as a guide to us and to interested parties in determining whether proposed initial rates should be certificated without a price condition and whether proposed rate changes should be accepted or suspended.
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> • • • • • • • • • •
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> "These price levels, as announced by Appendix A attached to this statement, are for the purpose of guidance and initial action by the Commission and their use will not deprive any party of substantive

rights or fix the ultimate justness and reasonableness of any rate level."[7]

In its opinion the Commission said further: "This schedule of prices is only for guidance and does not constitute any determination of just and reasonable rates and will not foreclose any person from justifying a particular rate in any area." The schedule is of maximum acceptable rates for gas from a given area, as opposed to rates established for each rate filing by each producer after a full cost-rate base consideration of each rate so filed.

The Commission disposed of the consolidated cases before it in three parts. The first part consisted of the superseded rates of the prior periods ("locked-in" periods). The second consisted of the presently current rates and those to be in effect during the interim period from now until the newly proposed area-rate system is completely designed and put into effect. The third part consisted of rates for the future after the completion and inauguration of the area-rate system.

Before we consider these several dispositions in detail we must understand the problem with which the Commission was dealing. The rates proposed to be increased in these 4(e) proceedings are not the rates of utilities in the traditional sense, such as pipelines. The rates here involved are the charges made by companies which buy or produce a product, process it to suit the requirements of a customer, and sell it to that customer under a contract. The product is procured from many different places, from Texas to West Virginia, from Louisiana to Wyoming. In its raw state it is of many different contents. Different customers require different terms as to the physical qualities of the delivered article, points and

[7] Statement of General Policy No. 61-1, Sept. 28, 1960, 25 Fed. Reg. 9578 (Oct. 5, 1960).

terms of delivery, and other factors. Hundreds of producers, hundreds of contracts, and thousands of rate filings are involved.

When we use the terms "cost of service" or "rate base" in this context, we must be careful of the meaning we intend. There is a system-wide cost of service. This would be, as the words indicate, a computation for the entire Phillips system. But even so it would not be a computation for all Phillips operations, because the Company has many operations, such as those in petro-chemical fields, and sales of all sorts of petroleum products, and many sales not subject to federal regulation under present statutes. In fact the Company's gross income from sales of natural gas in 1955 was less than six per cent of its total gross income. So even a system-wide computation of cost of service for sales of natural gas subject to Commission regulation requires monumental allocations of many costs, such as exploration costs, taxes, administration expenses, purchases, extraction costs, sales of residue gas and liquids, and so on. Nevertheless such a computation was made. The Examiner and also the Commission determined and used a system-wide cost of service. As found by the Commission the system-wide cost of service for Phillip's sales of natural gas subject to Commission jurisdiction in the test year 1954 was $55,548,054, or 11.309 cents per Mcf. But even the figure thus carefully computed was subject to adjustment for purchased gas costs, gathering taxes, and royalties. The same observations apply to the rate base on a system-wide basis. One was determined by the Commission.

Then, theoretically at least, there is a cost of service for each contract, if not for each rate, and so for each 4(e) proceeding. But nobody, so far as we are advised, contends that any such computations could be made with any meaningful results by any known method. The results of any such effort would be pure guesswork, involv-

ing a vast multiplication of the arbitrary allocations which would have to be made.

The Examiner did not attempt to make any cost-of-service determination on individual contract, rate, or case basis. He determined a system-wide cost of service, which gave him a nationwide average unit cost of 11.662 cents per Mcf. He then proposed that "[b]ased on the system-wide cost of service herein approved, as set forth in Appendix Table 12 hereof, Phillips shall calculate the 'maximum rate for 1,000-pound, sweet, dehydrated, and gathered gas,' at such level that its application to the sales volumes delivered in 1954 under each and every one of the 1954 jurisdictional contracts, as adjusted for the approved delivery condition rate differentials, will produce total revenues roughly equal to such system-wide cost of service." He proposed further that "Phillips shall file with the Commission a statement of such 'maximum rate,' including a clear and detailed explanation as to the manner in which it was calculated, together with a list of *calculated rates* for all of its jurisdictional rate schedules then in effect." The Commission, as we have said, reversed the Examiner, treating the case, in effect, in three parts.

1. As to the first part of the problem, the 4(e) proceedings, dealing with suspended proposals now superseded, the Commission made system-wide conclusions as to jurisdictional sales and applied them to these cases. It found $45,568,291 of revenues against $55,548,054* cost of service. This showed a system-wide deficit of some $9,000,000 on jurisdictional sales of natural gas. The Commission noted that no evidence had been presented to show that the different rates in these different (4(e)) proceedings were unduly discriminatory or preferential, which notation, translated, means that any adjustment in

* Modified to $54,525,315 after rehearing.

these rates should be correspondingly proportionate in respect to each and all. The Commission applied the result of its system-wide calculations to each and all of the 4(e) proceedings and concluded that no refunds were due. Having thus ordered, it concluded ("terminated") the proceedings.

The Commission made no determination of the cost of service of each of these contract rates separately; it had no evidence before it upon which it could make such determinations, and it was of opinion that such computations would be unworkable and foolish under the circumstances.

In these 4(e) cases, as we have pointed out, the Commission was dealing with a locked-in period. The revenues derived from the rates at issue had been impounded. The only question of substance in respect to that period was whether refunds should be made. The Commission decided that question, flatly and directly. No other question remained in those cases for decision. They presented no questions as to rates to be charged. Each presented the question whether a refund was due that customer for the past period and, if so, how much. Having made three determinations—(1) that there was a deficit of some $9,000,000 a year in revenues against cost of service, (2) that the increases involved totaled about five and a half million dollars and so, if allowed in full, would not wipe out the operating deficit, and (3) that any adjustments should be proportionate to all contract rates—it concluded that no refund was due on any contract, *i.e.*, in any 4(e) proceeding. Section 4(e) pertinently says that the Commission "may" order a refund of "the portion of such increased rates or charges by its decision found not justified." We cannot say that a deficit justifies or requires a refund or that the Commission was unlawfully arbitrary in reaching that result from the premises.

We think the Commission's course was reasonable and tenable. Surely, if only a single rate had been involved,

and enough evidence were introduced to justify, under testing, a conclusion that the company was operating at a deficit under that rate, it would not be necessary that evidence be taken to establish the precise penny amount of the deficit in order to support a reasonable inference by the Commission that no refund was indicated. Of course, in the matter at bar a number of rates in separate cases were involved, but the principle of procedure and the scope of permissible inferences from basic facts are much the same as in the suggested illustration. We think the facts support the conclusion.

It is argued that the Commission did not declare the rates under consideration to be just and reasonable or the contrary; that, instead, it "terminated" the proceeding. The contention is that the Commission made no decision. We think the point is not well taken. The Commission did make a clear decision, after elaborate findings, upon the one substantive issue before it. It did say it "terminated" the proceedings, but it terminated them after deciding the basis and dispositive issue, and it entered an order on that decision. Its "termination" was much like that of a judge after he had rendered findings, conclusion and judgment.

Whether the Commission should have preceded its ultimate conclusion of no-refund with an intermediate conclusion of justness and reasonableness in the rates at issue, and whether it properly added the termination order to its decisive finding, seem to us to be immaterial queries. The important feature is that the Commission reached and decided the critical substantial issue, rationally and upon detailed findings of basic facts upon an ample record.

This is not a *Minneapolis Gas*[9] situation, in which the Commission did nothing but simply terminated the pro-

[9] Minneapolis Gas Company v. Federal Power Commission, —— U.S. App. D.C. ——, 294 F.2d 212 (D.C.Cir. 1961).

ceeding without passing upon any of the disputed issues before it.

2. The case yields to clearer treatment if we next consider the part of the Commission's treatment which is last in chronological order, that is, the determination of rates for the future. As to these rates the Commission embarked upon the formulation of a new method of fixing just and reasonable rates for producers. It inaugurated hearings for that purpose. We think we need not explore the possibilities of success in that venture, or stop here to describe the projected scheme previously outlined in this opinion. In general it is referred to as an area-price method: it aims to establish proper prices for the gas rather than for the seller thereof. The Congress has confided the regulation of the natural gas industry to the Commission, not to the courts. The Supreme Court has said several times that the Commission is not bound to any one method or to known methods. The regulation of gas producers is a new project. Obviously, as is cogently pointed out in this record, it presents new and complex facts and problems. It would be foolish for the courts to hold that the Commission is bound to apply to these new conditions the methods and measurements designed and used for other and different regulatory purposes. We think it is clear that the Commission had ample authority to embark upon an effort to design suitable new standards for use in the regulation of producers when it found that the tools at hand were not suited to this purpose. The Commission abandoned the pending 5(a) proceeding in which it had been endeavoring to establish rates for the future by methods it now deems inadequate. We see no reason why it should not have done so.

3. The difficult part of the case before us concerns the second, or middle, part of the Commission's disposition. This involves the rates for the period from 1959 until the new system—or a new system—is designed and established.

This period will be long, estimates running from four to fourteen years. The rates during this period may, theoretically, be (1) rates in effect without increases having been proposed after January 1, 1959, (2) rates proposed to be increased since that date and suspended under Section 4(e), (3) rates for which increases may be proposed after the present time, (4) initial rates, *i.e.*, rates under new contracts made after January 1, 1959.

To meet the need for interim regulation the Commission took several steps. It published the policy statement which we have described. That announcement contained several components. First, the Commission said that in determining its own *sua sponte* action in respect to rates (*i.e.*, suspending proposed increases or inaugurating inquiries into existing rates) it would be guided by the guide rates. Second, it said that persons attacking rates (*i.e.*, customers and consumers) would be required to present evidence as to the industry generally in the area concerned, as well as the traditional evidence relating to the individual producer involved. Third, it said that "[a]s experience and changing factors may indicate," it would change the areas designated and likewise change the guide prices. Fifth, [sic] it said it will use its guide rates in disposing of 4(e) (*i.e.*, suspended proposed increases) proceedings arising upon increases proposed since January 1, 1959.

Refraining from exploring the various arguments, and argumentative trails, pointed out to us by the parties, we come directly to the crux of this problem. Has the Commission power under the Natural Gas Act to do what it did? Can it adopt upon the basis of its own expertise and its files, without a record made in the open in respect to the specific subject matter in issue, and without hearing, a set of guide lines by which it will be controlled in its regulatory functions during an interim period while it is attempting to perfect a suitable system for permanent regulation? We think it can.

In the first place, and throughout, we must remember that the Congress has power to direct the regulation of interstate commerce, and it has placed that regulatory power over natural gas in the Power Commission. We must remember that the problem at bar concerns a regulatory power. We are not considering adjudicatory, or quasi-judicial, power. It has long since been established that rate-making is a legislative function, and it is so defined in the Administrative Procedure Act.

Regulation poses many difficult problems. New regulation poses acutely difficult problems. Solutions oftentimes develop slowly. Many illustrations of that fact could be called to mind.

What power has the Commission in respect to interim regulation while the permanent structure is being designed and erected? Must it use means and methods long established for use in respect to other and different regulatory necessities? Or may it design from its own judgment and accumulated data a new method designed for the new problem? The differences between a public utility, such as a pipeline rendering a service by means of a fixed plant and operation, and a producer, who discovers or buys a product where, when and under such terms as he may, and sells that product under contracts negotiated on the open market, are too evident to justify elaboration. Whether the method thus designed and put into use by the Commission is good or bad is no part of our problem. Our inquiry is whether it was within the orbit of statutory authority and whether it was within constitutional limitations. We turn to those questions.

The Natural Gas Act is broad in its bestowal of power. It declares that all rates demanded by a company in connection with the sale of gas in interstate commerce for resale shall be just and reasonable. Section 4(a). A gas company files with the Commission schedules of its rates. Section 4(c). If a company proposes to increase a rate,

it must file a new schedule. The Commission may then enter upon a hearing concerning the "lawfulness" of the proposed rate. Section 4(e). If the Commission, on its own motion or upon complaint, finds a rate unjust, unreasonable, unduly discriminatory or preferential, the Commission "shall" determine the just and reasonable rate. Section 5(a). Of course, constitutional restrictions apply; rates fixed by governmental authority cannot be confiscatory; all procedures must be by due process, that term conveying meanings differing according to the basic nature of the proceeding but always including that which is fair and decent according to the standards of our social order and time.

The statute contains no definition of a "just and reasonable" rate. It is established by tradition and by many court decisions that for a public utility, rendering service by use of fixed equipment, a just and reasonable rate is one which returns a fair profit upon the investment, or which supplies the utility with adequate revenues to command needed funds upon an economically reasonable basis. But what of a fair price for a commodity bought and sold by a merchandiser? Almost the whole of the economics of merchandizing differs from the economics of public utility service. Are the just and reasonable prices of such a merchandiser limited to fair returns on his own investment and prices paid by him (and, if so, what investment and what prices), or are those prices reasonably measured by the fair prices for the product as measured by the open competitive market for the product, evaluated by Commission expertise and data on the whole of the market operation? Either criterion is a method of regulation. It seems to us that the choice must lie with the Commission.

Let us emphasize that we do not have before us at this time the question whether any rate set by the Commission as a guide rate falls within the area of reasonable computation. That question is emphatically left open by

the Commission, and by us, for consideration when some one or more of the selected guide rates is attacked, by a producer, a customer, or a consumer. The problem here at this time is merely whether the Commission may embark upon this method of regulation. Since it is the Commission's judgment that this method is best suited for the regulation of these prices, for the determination of their justness and reasonableness, we find in the statute nothing to deny a trial of the method.

Of course, conceivably, justness and reasonableness from the standpoint of the consumer might be defined as limiting the vendor's return to a fair amount on his investment, and his price accordingly. But, if the government agency charged with the responsibility in the public interest finds, after elaborate accumulation of data, that such a measurement is unworkable, may not a fair price for the product reflected on the open market, after scrutiny and adjustment by the government agency concerning the factors which produced that price, be just and reasonable for the consumer? Of course the agency would be required to be alert for artificial impulses in such a fair area price, and the avenues of attack by consumers would have to be kept open without obstruction; but, if the latter is avowed, how could we assume in advance that the agency would not protect the consumer as it is charged by the Congress to do? The Commission is not here proposing to accept a field price, or any other price as is. It has announced guideline rates which it deems to be, on the basis of the internal data in its files on all the operators in the several areas, fair rates for the product in those areas. Such rates, thus determined, would seem to be just and reasonable rates for the consumers of the product. And, similarly, they would seem to be just and reasonable charges for the producers to make.

As to the constitutional question of confiscation, it would seem to us that the question should await proof presented

by a producer in respect to a particular rate in a particular area.

Thus we come to conclude that the interim method of regulation proposed by the Commission does not appear at this point in the process to be violative of either statutory or constitutional limitations.

It is urged upon us that the Commission has abandoned regulation of these rates for this interim period. We do not agree with the view. It has certainly changed the method of regulation, or, more precisely, the standards by which it will apply its regulatory power. It has abandoned case-by-case, contract-by-contract measurements on a cost-of-service rate-base basis. It has installed an area fair price measurement for the prices of the product to be sold. In so doing it has abandoned a method it finds to be unworkable and foolish in favor of a method it deems to be workable and just and reasonable. If that be so, instead of abandoning regulation it is making regulation effective. The choice it faced, at least in its own view, was not between regulation or no regulation but was between effective and ineffective regulation.

If, as some consumer interests fear, the new process turns out to be ineffective in the protection of their interests, the way is open for them to challenge the results; as we have pointed out, that way must be kept open. New rates and increases in rates proposed during this interim will be subject to suspension and refund, and so the rights of customers will be fully protected. The new method will also apply in 5(a) proceedings to any existing rate found to be unjust or unreasonable. Refunds cannot be ordered in the latter cases and so consumers bear the disputed rates during the period of the inquiry. But this same situation obtains in the present process of regulation; the application of the new criteria makes no change in this procedural aspect. In the case at bar the Commission has found, after elaborate consideration, that pres-

ent rates result in deficits to the Company. Consumers have no tenable ground for complaint of such rates. So it seems to us that the interests of consumers are amply protected during this interim period; at least a contrary effect should await the event for us to disturb the view of the Commission, based as it is upon this record.

There remains for discussion a point concerning two 4(e) proceedings which were not terminated. They involved proposed increases based upon escalator clauses in two of Phillips's contracts. These contracts were made before producers such as Phillips were subject to regulation. They were with pipeline companies, as customers, which were subject to regulation. The contracts provided that, if the pipeline companies were granted increases in the rates they could charge, Phillips in turn would receive increases in the rates it charged these customers. These customers had proposed increases, and they were pending in 4(e) proceedings. The Commission ordered that upon decisions in the customers' rate cases Phillips's cases would be acted upon.

Wisconsin and California contend that the Commission should now declare these escalator clauses to be illegal and void as against public policy. As a matter of fact the Commission has declared these clauses to be against the public interest and that they should be held inoperative. But, the Commission says, in so far as these cases of Phillips are concerned, action of the sort demanded by Wisconsin and California is premature. Action on these clauses, it says, should await action on the pending cases which in orderly processes present the problem for decision. We agree with the Commission.

Affirmed.

FAHY, *Circuit Judge, dissenting, with partial concurrence:* I am not able to agree that the order of the Commission terminating the section 4(e)[1] and section 5(a)[2] proceedings should be affirmed. I think the cases should be remanded to the Commission for decision.

While the Commission advances strong reasons for abandoning cost of service as a method of determining the justness and reasonableness of the rates of independent producers of gas, a careful reading of the Commission's opinion demonstrates that the Commission's conclusion that such a method is unworkable follows from a generalized view of the problem of producer rates rather than from the inability of the Commission to utilize the cost of service method in these Phillips cases.

Embarkation upon the area method preferred by the Commission does not necessitate judicial intervention, certainly not at this time; for judicial review must await a Commission order based upon that method. We should not seek to deter the Commission from pursuing such a method in future proceedings, or from using it in any proceedings already initiated along those lines. But it does not follow in my opinion that the Commission should be affirmed in failing to decide the present cases, though it may need to update the record. In the same breath as it were in which it describes the unworkability of the cost of service method the Commission itself accepts that precise method in finding that no refunds are to be required in the section 4(e) proceedings, stating:

> While we have found that the rate base method is not an effective means of regulating the producers' prices, evidence in this proceeding was presented almost entirely upon the cost basis and, of course, there were no ceiling prices issued by us at the time of the

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[1] 52 Stat. 822 (1938), 15 U.S.C. § 717c (1958).

[2] 52 Stat. 823 (1938), 15 U.S.C. § 717d (1958).

hearing. There was some field price evidence introduced, but if field prices could be employed in arriving at rates for Phillips, the evidence was incomplete and unrepresentative of Phillips' diverse sales. Therefore we shall proceed on the basis of the evidence adduced in this case to reach conclusions, as reasonable, intelligent and logical as possible even though we know and have herein stated the difficulties inherent in detemining a cost of service for Phillips using the rate method. This is clearly a lawful way to determine rates for Phillips as illustrated by the *City of Detroit* case,[11] and under the present record is the only possible method, and therefore we shall make every effort to reach a result by this means.

[11] *City of Detroit* v. *F.P.C.*, 230 F. 2d 810 (CADC), *certiorari* denied, 352 U.S. 829.

The Commission could as well have proceeded with supplemental data, to decide the question of justness and reasonableness of the rates in the section 4(e) proceedings, and, also, to have determined under section 5(a) the just and reasonable rates to be thereafter observed and enforced.

This view is strongly fortified by the able decision of the Presiding Examiner. After an illuminating analysis of the voluminous record made on a cost of service basis he was able to propose definitive decisions. The record had been made with the cooperation of all parties, Phillips itself affirmatively acquiescing in the position that cost of service was the appropriate basis on which to proceed. Phillips' position, as the Examiner points out, was that its jurisdictional rates should be determined upon the basis of an overall cost of service.

It is one thing to say, as the Commission does, that the area method should hereafter be adopted, or even adopted in other cases which have not proceeded as far as those before us. It is quite another thing to say that the latter

should not be decided under the standards of the Act because the area method was not used in preparing the record. Unless decided Phillips' challenged rates are left undetermined under the standards of the Act since 1948, and apparently will continue to remain undetermined until some future day when new proceedings, now in an inchoate status with no end in sight, are concluded. Difficult and complicated as the tasks of the Commission admittedly are I cannot agree after reading the Examiner's decision or the Commission's findings that the congressional mandate of section 4(e), which requires that these matters shall be decided "as speedily as possible," is being complied with, or that the responsibilities of the Commission under the Act are discharged in the situation resulting from the termination order.

These cases need not be treated as if they were ventures initiated in search of an ideal method of regulating the rates of independent gas producers. Having in mind the history of these proceedings, and the primary congressional purpose of consumer protection, it seems to me that decisions on the present record, supplemented as may be found to be reasonably necessary, would be far more likely to approximate fulfillment of the purposes of the Act than are the termination order and the resulting situation.

The Commission says it has a discretion to terminate as well as to initiate; but once it has exercised its discretion to initiate and has pursued the matter to the extent we find here its discretion to terminate is not as broad as was its discretion to initiate. The former becomes limited by the conditions existing at the time of its exercise: *Minneapolis Gas Co.* v. *Federal Power Comm'n*, —— U.S. App. D.C. ——, 294 F.2d 212. Compare *Eastern Air Lines, Inc.* v. *Civil Aeronautics Board*, —— U.S. App. D.C. ——, 294 F.2d 235.

The Commission has actually found Phillips' cost of service on the basis of the record made and has arrived

on the same record at a proper rate of return, stating "this is clearly a lawful way to determine rates for Phillips as illustrated by the *City of Detroit* case, . . . and under the present record it is the only possible method . . . ." In this manner the Commission has come so close to doing what it says it should not do as to demonstrate that it is able to do what it has failed to do.

The finding of the Commission in the section 4(e) proceedings that there could be no refunds because the cost of service exceeded the revenues on the basis of the data for the 1954 test year, I think does not justify the order terminating all but two of the section 4(e) proceedings, or the Commission's invitation to Phillips to move to terminate all others which are still pending. The absence of a decision on the issue of justness and reasonableness of rates has the effect of leaving all rates subsequent to 1954 untested under the standards of the Act. Substance is not achieved merely by finding whether or not refunds were due on the basis of the 1954 data. A finding in that regard should not be independent of a finding of the just and reasonable rates. The former should follow from the fact that the just and reasonable rates are not exceeded by those in effect.

The decision of these cases under the standards of the Act not only would not preclude the Commission from embarking upon the area method but it also would not preclude the Commission from correcting or modifying the decision should the area proceeding show such correction or modification to be desirable; nor do I think a decision on the present record, supplemented as may be needed, would preclude the Commission, pending conclusion of an area proceeding, from establishing guides, formulated, however, with the aid of a decision in the present proceedings.

I agree with Judge Prettyman as to the prematurity of the request for action on two section 4(e) proceedings which have not been terminated.

APPENDIX B

On Petitions for Review of Order of the
Federal Power Commission

Before: Prettyman, Fahy and Danaher, Circuit Judges.

Judgment

These cases came on to be heard on the record from the Federal Power Commission, and were argued by counsel.

On Consideration Whereof, It is ordered and adjudged by this court that the order of the Federal Power Commission on review in these cases is affirmed.

Per Circuit Judge Prettyman

Dated: November 30, 1961

Separate dissenting opinion by Circuit Judge Fahy, with partial concurrence.

APPENDIX C

Natural Gas Act

The pertinent provisions of the Natural Gas Act of June 21, 1938, c. 556, 52 Stat. 821; as amended, 15 U.S.C. §§ 717-717w, are as follows:

Section 4 (a) All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.

* * * * * * * * * *

(d) Unless the Commission otherwise orders, no change shall be made by any natural-gas company in any such rate, charge, classification, or service, or in any rule, regulation, or contract relating thereto except after thirty days' notice to the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. The Commission, for good cause shown, may allow changes to take effect without requiring the thirty days' notice herein provided for by an order specifying the changes so to be made and the time when they shall take effect and in the manner in which they shall be filed and published.

(e) Whenever any such new schedule is filed the Commission shall have authority, either upon complaint of any State, municipality, or State commission, or upon its own initiative, without complaint, at once, and if it so orders without answer or formal pleading by the natural-gas company, but upon reasonable notice, to enter upon

a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the natural-gas company affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect: *Provided*, That the Commission shall not have authority to suspend the rate, charge, classification, or service for the sale of natural gas for resale for industrial use only; and after full hearings, either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made at the expiration of the suspension period on motion of the natural-gas company making the filing, the proposed change of rate, charge, classification, or service shall go into effect. Where increased rates or charges are thus made effective, the Commission may, by order, require the natural-gas company to furnish a bond, to be approved by the Commission, to refund any amounts ordered by the Commission, to keep accurate accounts in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts were paid, and, upon completion of the hearing and decision, to order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the natural-gas company, and the Commission shall give to the hearing and decision of such questions prefer-

ence over other questions pending before it and decide the same as speedily as possible.

[52 Stat. 822 (1938); 15 U.S.C. § 717e]

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Section 5. (a) Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: *Provided, however*, That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural-gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural-gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates.

[52 Stat. 823 (1938); 15 U.S.C. § 717d]

• • • • • • • • • • •

Section 19. (a) . . .

(b) Any party to a proceeding under this chapter aggrieved by an order issued by the Commission in such proceeding may obtain a review of such order in the court of appeals of the United States for any circuit wherein the natural-gas company to which the order relates is located or has its principal place of business, or in the United States Court of Appeals for the District of Columbia, by

filing in such court, within sixty days after the order of the Commission upon the application for rehearing, a written petition praying that the order of the Commission be modified or set aside in whole or in part. A copy of such petition shall forthwith be transmitted by the clerk of the court to any member of the Commission and thereupon the Commission shall file with the court the record upon which the order complained of was entered, as provided in section 2112 of Title 28. Upon the filing of such petition such court shall have jurisdiction, which upon the filing of the record with it shall be exclusive, to affirm, modify, or set aside such order in whole or in part. No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission in the application for rehearing unless there is reasonable ground for failure to do so. The finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. If any party shall apply to the court for leave to adduce additional evidence, and shall show to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence in the proceedings before the Commission, the court may order such additional evidence to be taken before the Commission and to be adduced upon the hearing in such manner and upon such terms and conditions as to the court may seem proper. The Commission may modify its findings as to the facts by reason of the additional evidence so taken, and it shall file with the court such modified or new findings, which if supported by substantial evidence, shall be conclusive, and its recommendation, if any, for the modification or setting aside of the original order. The judgment and decree of the court, affirming, modifying, or setting aside, in whole or in part, any such order of the Commission, shall be final, subject to review by the Supreme Court of the United States upon certiorari or certification as provided in section 1254 of Title 28.

[52 Stat. 831 (1938) as amended, Aug. 28, 1958, Pub. L. 85-791, § 19, 72 Stat. 947, 15 U.S.C. § 717r.]

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Supreme Court of the United States

OCTOBER TERM, 1961

No. ~~754~~ 72

STATE OF WISCONSIN AND PUBLIC SERVICE COMMISSION OF WISCONSIN, AND PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK, *Petitioners*

v.

FEDERAL POWER COMMISSION AND PHILLIPS PETROLEUM COMPANY, *Respondents*.

No. ~~755~~ 73

PEOPLE OF THE STATE OF CALIFORNIA AND PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, *Petitioners*

v.

FEDERAL POWER COMMISSION AND PHILLIPS PETROLEUM COMPANY, *Respondents*.

No. ~~756~~ 74

LONG ISLAND LIGHTING COMPANY, PHILADELPHIA ELECTRIC COMPANY AND THE UNITED GAS IMPROVEMENT COMPANY, *Petitioners*

v.

FEDERAL POWER COMMISSION AND PHILLIPS PETROLEUM COMPANY, *Respondents*.

On Petitions for Writs of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

MOTION OF PHILLIPS PETROLEUM COMPANY TO CORRECT AND AMEND TITLE AND CAPTION AND BRIEF FOR RESPONDENT IN OPPOSITION

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1961

No. 754

STATE OF WISCONSIN AND PUBLIC SERVICE COMMISSION OF WISCONSIN, AND PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK, *Petitioners*

v.

FEDERAL POWER COMMISSION, *Respondent*.

No. 755

PEOPLE OF THE STATE OF CALIFORNIA AND PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, *Petitioners*

v.

FEDERAL POWER COMMISSION, *Respondent*.

No. 756

LONG ISLAND LIGHTING COMPANY, PHILADELPHIA ELECTRIC COMPANY, AND THE UNITED GAS IMPROVEMENT COMPANY, *Petitioners*

v.

FEDERAL POWER COMMISSION, *Respondent*.

On Petitions for Writs of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

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MOTION OF PHILLIPS PETROLEUM COMPANY TO CORRECT AND AMEND TITLE AND CAPTION

Phillips Petroleum Company, a corporation (hereinafter called Phillips), hereby respectfully moves this Honorable Court for a rule or order to correct and

amend the title and caption of this proceeding to show "Phillips Petroleum Company" as a party respondent, and to permit Phillips to file briefs in this proceeding as a respondent, upon the following grounds and for these reasons:

I.

In the Court of Appeals for the District of Columbia Circuit from whose decision writs of certiorari are sought, the parties were aligned with Petitioners herein, and the Public Service Commission of the State of New York, Intervenor, on one side, and the Federal Power Commission as Respondent, and Phillips as Intervenor-Respondent, on the other side. As an Intervenor-Respondent in the proceedings, Phillips filed a brief in support of the order of the Federal Power Commission and participated in the oral argument to the Court of Appeals for the District of Columbia Circuit.

II.

Phillips is the real party in interest in these proceedings. Petitioners seek writs of certiorari to the Court of Appeals for the District of Columbia Circuit for the review by this Court of the decision of the Court of Appeals affirming the order of the Federal Power Commission dismissing proceedings, under Sections 4(e) and 5(a) of the Natural Gas Act, involving the rates of Phillips for sales of natural gas in interstate commerce for resale. In their petitions, the Petitioners request this Court to order the Federal Power Commission to reopen the proceedings and to continue its investigation of the rates of Phillips.

III.

Each of the Petitioners, at the time of filing its petition for writ of certiorari in this Court, promptly served a copy of its petition on Phillips. In addition, each Petitioner, pursuant to Rule 21(1), has formally notified Phillips of the filing of its petition and of the contents of the record filed, all upon the printed forms supplied for use in this Court. In No. 754 and No. 755, such notices were directed to counsel for Phillips as "Counsel for Respondent". In No. 756, such notice consisted of a copy of the notice to the Hon. Archibald Cox, Solicitor General of the United States.

IV.

In addition to the foregoing, Phillips respectfully asserts:

(a) That it is a full party, and a real party in interest, in the proceedings here as it was in the court below;

(b) The denial of such party status to Phillips would deny to Phillips its day in this Honorable Court to defend its substantial rights;

(c) Any judgment altering these rights in any proproceeding in which Phillips is not a party would injuriously affect its interest and would constitute a denial to Phillips of due process of law under the Fifth Amendment to the Constitution of the United States.

WHEREFORE, Phillips respectfully prays that this Court issue its rule or order correcting and amending the title and caption of this proceeding by showing Phillips Petroleum Company as one of the respondents

and permitting Phillips to participate in this proceeding as a respondent.

Respectfully submitted,

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1961

No. 754

STATE OF WISCONSIN AND PUBLIC SERVICE COMMISSION OF WISCONSIN, AND PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK, *Petitioners*

v.

FEDERAL POWER COMMISSION AND PHILLIPS PETROLEUM COMPANY, *Respondents.*

No. 755

PEOPLE OF THE STATE OF CALIFORNIA AND PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, *Petitioners*

v.

FEDERAL POWER COMMISSION AND PHILLIPS PETROLEUM COMPANY, *Respondents.*

No. 756

LONG ISLAND LIGHTING COMPANY, PHILADELPHIA ELECTRIC COMPANY AND THE UNITED GAS IMPROVEMENT COMPANY, *Petitioners*

v.

FEDERAL POWER COMMISSION AND PHILLIPS PETROLEUM COMPANY, *Respondents.*

On Petitions for Writs of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

BRIEF FOR RESPONDENT PHILLIPS PETROLEUM COMPANY IN OPPOSITION

OPINIONS BELOW

The Opinion and order of the Federal Power Commission (R. 251-342) is reported at 24 FPC 537, and the Commission's Order Denying Rehearing (R. 395-

404) is reported at 24 FPC 1008. The decision of the Presiding Examiner (R. 35-217) is reported at 24 FPC 590. The opinion of the Court of Appeals is not yet reported (Appendix A to the Petitions).

JURISDICTION

The jurisdictional requisites are adequately set forth in the Petitions.

QUESTIONS PRESENTED

The principal question presented is:

1. May the Federal Power Commission terminate its investigation of the rates of an independent producer under Sections 4(e) and 5(a) of the Natural Gas Act after reviewing the record and making unchallenged findings that (1) test year cost of service substantially exceeded test year revenues (after allowing for Section 4(e) increases), (2) there is nothing to show that existing rates are unduly discriminatory or preferential, and (3) at the time of decision in 1960, the 1954 test year is not suitable for fixing future rates?

An additional question which is presented only in No. 755 is:

2. May the Federal Power Commission refuse to reject a rate increase based on contractual provisions which (after a specified increase in the wholesale commodity index) permit a producer to increase its price in proportion to an increase in the resale rate of the pipeline company purchaser, where the Commission considered such provisions as constituting nothing more than contractual consent to a rate increase which must be otherwise justified?

STATUTE INVOLVED

The statute involved is the Natural Gas Act (52 Stat. 821-833, as amended; Title 15 USC, Secs. 717-717w). The pertinent provisions are printed in Appendix E to the Petition in No. 754; Appendix B to the Petition in No. 755, and Appendix C to the Petition in No. 756.

STATEMENT

I. The Proceedings Before the Commission

Following the decision of this Court in *Phillips Petroleum Company* v. *Wisconsin*, 347 U.S. 672 (1954), the Federal Power Commission (Commission) reinstituted its investigation into the rates of Phillips Petroleum Company (Phillips). In addition to its general investigation under Section 5(a) of the Natural Gas Act (Act), the Commission by orders issued May 8, 1956 and April 26, 1957 (R. 21, 27) consolidated twelve separate proceedings involving rate increases of Phillips which were suspended pursuant to Section 4(e) of the Act. Except in one minor case (Docket No. G-8623 involving an annual increase of $21,234, R. 325) all of these Section 4(e) docket proceedings have been superseded by other rate increase filings which have been suspended and are still pending before the Commission in other dockets.

Hearings began in June 1956 and extended to December 1957. Voluminous evidence was received. Phillips, the Commission Staff, and thirty-one Intervenors actively participated in the hearings (R. 252).

Following the close of hearings, the Examiner presiding at the hearings issued a lengthy decision (R. 35-217). Numerous exceptions to his decision were then filed with the Commission. On September 28,

1960, the Commission issued a comprehensive opinion reviewing and passing upon the issues presented and allowing and disallowing exceptions to the Examiner's decision (R. 251-342). On November 25, 1960, the Commission issued its order passing upon applications for rehearing filed by various intervenors, amending in part its previous opinion and order and otherwise denying the applications for rehearing (R. 395-402).

II. The Opinion of the Commission

The Opinion of the Commission fulfilled two separate functions. In major part it was a determination by the Commission, based upon the evidence of record in this proceeding, of the cost of service of Phillips' natural gas operations for a test year (1954) and a comparison of that cost of service with the revenues provided by Phillips' contract rates (R. 269-342). This portion of the Commission's opinion dealt solely with Phillips, was based on evidence which applied equally and without distinction to both the Sections 4(e) and 5(a) proceedings, and in substance constituted an application by the Commission to Phillips' rates of cost principles of the kind referred to in *City of Detroit* v. *Federal Power Commission*, 230 F. 2d 810 (CADC, 1956, cert. den. 352 U.S. 829).

In addition, the Commission used its decision as a vehicle in which to discuss, based upon its experience in this and other cases involving independent producers, the impracticality and unworkability of individual company cost of service as the basic tool by which to regulate all independent producers (R. 256-269). As a part of that discussion (R. 266), the Commission announced that by separate document (Statement of General Policy No. 61-1, not docketed as a part of this

proceeding) it was describing and inaugurating a different method of regulating producers to be adopted in future proceedings (R. 343-348). It is this separate document which draws much of the attention of Petitioners.

With regard to the Phillips contract rates which were before it in this proceeding, the Commission stated:

> "While we have found that the rate base method is not an effective means of regulating the producers' prices, evidence in this proceeding was presented almost entirely upon the cost basis and, of course, there were no ceiling prices issued by us at the time of the hearing. There was some field price evidence introduced, but if field prices could be employed in arriving at rates for Phillips, the evidence was incomplete and unrepresentative of Phillips' diverse sales. Therefore we shall proceed on the basis of the evidence adduced in this case to reach conclusions, as reasonable, intelligent and logical as possible even though we know and have herein stated the difficulties inherent in determining a cost of service for Phillips using the rate base method. This is clearly a lawful way to determine rates for Phillips as illustrated by the *City of Detroit* case, and under the present record is the only possible method, and therefore we shall make every effort to reach a result by this means." (R. 269)

The Commission then proceeded to make specific findings. It determined the cost of service for Phillips for the test year (R. 322). It found that the cost of service exceeded the revenues provided by the contract rates (R. 326) by more than nine million dollars per year (based upon the modified cost of service set forth in the order on rehearing, R. 401). It found that Phillips' existing contract rates were not unduly dis-

criminatory or preferential (R. 325). It found that the Section 4(e) increases consolidated with this proceeding had been superseded by further increases, that these superseded rate increases had produced revenues less than cost while they were in effect, and that none of these increases was unduly discriminatory or preferential (R. 325-326).

Based upon its findings that cost of service exceeded revenues, the Commission terminated both the Section 3(a) and Section 4(e) proceedings. It reviewed the greatly varying contentions of the parties regarding methods of fixing rates for the future (R. 323), which included (before the Examiner) the highly contested issue of whether the Commission was entitled to permit Phillips to increase its rates above contract levels (R. 75-86). It concluded that the record before it was not suitable for fixing rates for the future (R. 324-325). It likewise concluded there was little point in determining precise rates for the Section 4(e) increases, since these rates applied only to past periods and the Commission was holding that no refunds were required (R. 325-326).

Petitioners did not challenge the Commission's finding that this record was not suitable for fixing rates for the future. Instead, some of them requested that the Commission reopen the record and start what in effect would constitute an entirely new proceeding. The Commission considered this request to reopen and denied it (R. 396-397).

III. The Decision of the Court of Appeals

The Court of Appeals considered the Commission's decision separately from the standpoint of the Section 4(e) increases and the determination of future rates in

Section 5(a) proceedings. It reviewed, first, the termination by the Commission of the Section 4(e) cases. The Court held that the Commission's findings that costs exceeded the revenues provided by these increases, and that the rates were not unduly discriminatory or preferential, justified the termination of those proceedings. The Court specifically held that under the circumstances the Commission was not required to make intermediate (and in effect pointless) findings as to whether the individual rates were just and reasonable during the periods they were in effect. Secondly, the Court held that it was proper for the Commission to announce area rates as a proper method of fixing future rates for independent producers. The Court specifically denied Petitioners' contention that the Commission was abandoning or deferring regulation of producers.

With one Judge dissenting, the Court affirmed the Commission.

ARGUMENT

Petitioners would have the Court believe this case involves broad questions of administrative policy in the enforcement of the Natural Gas Act. Such questions are not presented on this record. This appeal is not from any order issued in an area rate proceeding but rather is confined to a rate order related to Phillips' operations. The action which the Commission took on the basis of the record before it was truly narrow in scope.

The record in this proceeding demonstrates that there are no grounds for granting a writ of certiorari. The petitions filed herein are bottomed on the supposition that this Court has the power and authority to tell

the Commission when it shall terminate a proceeding; when that proceeding must be expanded by reopening the record; and, on the basis of a new record, instruct the Commission as to the rate making formula it should adopt, all contrary to established holdings of this Court. *Interstate Commerce Commission* v. *Jersey City*, 322 U.S. 503, 514-515 (1944); *United States* v. *Pierce Auto Freight Lines*, 327 U.S. 515, 535 (1946); *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944); *Federal Power Commission* v. *Natural Gas Pipeline Co.*, 315 U.S. 575, 586 (1942); *Federal Communications Commission* v. *Pottsville Broadcasting Co.*, 309 U.S. 134, 137-138, 142, 143 (1940).

The substance of the Commission's decision was that, measured by a test year, Phillips' contract rates produced revenues less than its cost of service. In the course of its progress toward that ultimate finding, the Commission did decide many broad rate regulatory questions relating to allocation methods and principles of cost determination—but those broad questions which do exist in this record are not raised here. Other issues decided related solely to the particular situation of Phillips. As we will show (*infra*, p. 21), one of those—the issue raised by California relating to the so-called "spiral escalation clauses"—has lost much of its significance even as to Phillips.

The issues which Petitioners seek to inject into this proceeding are in reality issues relating to possible *future* action by the Commission in *other* proceedings. The Commission used its opinion in this proceeding as a vehicle to announce and describe a method of regulation which it intends to follow in future proceedings. It did not employ that new method in this case. On the contrary, it employed here the identical cost of service

principles which Petitioners now urge this Court to direct the Commission to follow in regard to the fixing of future rates for Phillips. Applying such cost of service principles, it made findings which Petitioners do not challenge.

Petitioners do not seek relief on the basis of this record. They do not want the Commission's action to be limited to the rate schedules which were before the Commission on this record. Petitioners are adamant that the record must be reopened and supplemented (in substance a new record in a new proceeding). In fact, it would appear that Petitioners' primary concern is not even with rates for Phillips. Petitioners seem far more concerned with obtaining a directive to the Commission to act in a particular fashion with respect to other producers in other proceedings.

If and when properly presented in proceedings in which the facts are appropriate, questions as to the validity or application of the proposed area rates may indeed be worthy of this Court's consideration. So far as this proceeding is concerned, such questions are presented in a vacuum. In the posture of the record in this proceeding, Petitioners' request to this Court constitutes nothing more than a request for the same type of advisory opinion which was sought from and refused by this Court in *United Public Workers of America* v. *Mitchell*, 330 U.S. 75, 89 (1946).

I. The Commission Has Done All That the Natural Gas Act Permitted It to Do on the Basis of This Record

Petitioners do not contend that, on the basis of the record before it, the Commission could or should have reduced Phillips' rates. The Commission found that

Phillips' costs exceeded the revenues provided by its contract rates (R. 326). Petitioners do not challenge that finding. The Commission did not find Phillips' contract rates to be either unjust and unreasonable or unduly discriminatory and preferential. No one now contends that it should have done so.

Absent findings that Phillips' rates were unjust and unreasonable, or unduly discriminatory and preferential, the Commission was powerless to prescribe rates for the future. Section 5(a) of the Act provides that:

> "Whenever the Commission . . . shall find that any rate . . . is unjust, unreasonable, unduly discriminatory or preferential, the Commission shall determine the just and reasonable rate . . . to be thereafter observed and enforced, and shall fix the same by order . . ."

This Court has said that such a finding is a "condition precedent" to the exercise of the Commission's rate fixing powers. *Federal Power Commission* v. *Sierra Pacific Power Company*, 350 U.S. 348, 353 (1956).

It is not a condition precedent to allowing existing rates to remain in force that the Commission hold existing rates to be just and reasonable. Quite to the contrary, this Court held in *Sierra, supra* (350 U.S. 354, 355) that, even though costs exceed contract rates, the Commission may not fix different rates unless it can hold the existing rates unjust and unreasonable as contrary to the public interest (as distinguished from the private interest of the company). Thus, the Commission may be obligated to permit a rate to remain in effect even though it could not hold such a rate to be just and reasonable and could not impose such a rate upon the affected natural gas company.

The assertion by Petitioners that the Commission has permitted Phillips' rates to remain in effect without finding that such rates are just and reasonable thus presents no question for review. The Commission did make the unchallenged finding that, on the basis of the record before it, such rates produced less than a fair return. The Commission did not find such contract rates to be so low as to be contrary to the public interest. Consequently, the Commission could not, within the limitations of *Sierra*, hold Phillips' existing rates to be unjust and unreasonable, set aside Phillips' contracts and permit Phillips to file increased rates. No one now contends that it should have done so.

On the basis of these unchallenged findings, termination of the proceedings was the only alternative left open to the Commission.

Petitioners' contentions stem from a misunderstanding of the purpose and intent of the Natural Gas Act. Petitioners seem to assume that contract rates are unlawful *per se* and that the Act contemplates only rates "fixed" by the Commission. They imply that the Commission has shirked its duty if it merely reviews contract rates and refuses, on the basis of the record before it, to "fix" a different set of rates. The theory of the Act is exactly opposite. In *United Gas Pipe Line Company* v. *Mobile Gas Service Corp.*, 350 U.S. 332, this Court stated that the Act ". . . evinces no purpose to abrogate private rate contracts as such" (350 U.S. at 338) and that the ". . . basic power of the Commission . . . is simply the power to review rates and contracts made in the first instance by natural gas companies and, if they are determined to be unlawful, to remedy them" (350 U.S. at 341).

In substance, the contention that the Commission has failed to "fix" the rates of Phillips is nothing more than a lament that, on the this record, the Act did not authorize such action. Because the Commission made unchallenged findings which did not authorize the alteration of the contract rates before it, Petitioners assert that the Commission has "abandoned" regulation. Such assertion cannot hide from this Court the fact that the alleged questions "of major and general importance" constitute nothing more than a plea that this Court direct the Commission to see whether it can do otherwise on the basis of a different record.

Petitioners did not challenge the Commission's finding that this record is unsuitable for the purpose of fixing rates for the future. Petitioners adopted the alternative course of asking the Commission to reopen the proceedings (R. 381-382). In the court below Petitioners sought to have the record reopened for incorporation of more recent data. The Commission specifically denied the motion to reopen (R. 396-397). Such action is clearly within the sole discretion of the Commission. *Interstate Commerce Commission* v. *Jersey City*, 322 U.S. 503, 514-515 (1944); *United States* v. *Pierce Auto Freight Lines*, 327 U.S. 515, 535 (1946); *City of Detroit* v. *Federal Power Commission*, 230 F. 2d 810, 822 (CADC, 1956, cert. den. 352 U.S. 829).

Petitioners' request that this Court direct the Commission to fix rates for the future is in substance a request for a direction to the Commission to institute a completely new proceeding. In fact, as the Commission found the 1954 test year to be no longer usable, it recognized in its order denying rehearing (R. 397) that a new full blown rate proceeding would be required.

Whether this proceeding should be reopened or whether Phillips' rates should be considered in a new proceeding is a matter for Commission decision and not the Courts. *Federal Communications Commission* v. *Pottsville Broadcasting Company*, 309 U.S. 134 (1940).

II. The Court Below Properly Held That the Choice of Methods of Regulation in Future Proceedings is the Sole Province of the Commission

The Commission decided this case on the basis of the cost of service as determined for Phillips (R. 269-272). It announced that in future proceedings it would employ a different method (R. 265-266). Contrary to the assertions of Petitioners, the Commission has neither abandoned nor deferred regulation of producers. It is proceeding along the course it has outlined for itself. In the words of the Court below, "... instead of abandoning regulation it is making regulation effective" (No. 756, Appendix A, page 18a).

The method which the Commission used to reach its conclusions with respect to Phillips' rates in this proceeding appears wholly acceptable to Petitioners. With regard to future proceedings, Petitioners feel their choice of method is superior to that of the Commission. Their assertions that the Commission has abdicated its jurisdiction and that it has indefinitely deferred regulation of producers is but a different way of saying that Petitioners desire the Court to force Petitioners' choice upon the Commission.

Petitioners envision great delay in further proceedings affecting Phillips and other producers. But there is, and could be, no showing here that a new proceeding

under procedures dictated by the Court would reach a conclusion faster than hearings under methods selected by the Commission. A new test year would have to be selected—a matter of possible dispute in itself—and new test year data would have to be prepared, always a lengthy process. New issues would likely arise from such new data. As we have indicated, Petitioners express far more concern with the rates of others than with the rates of Phillips. It is but idle speculation to assert that review of all producers' rates will be accomplished faster on a one-by-one basis than in proceedings involving all producers simultaneously.

The asserted injury to the consuming public pending completion of future proceedings is wholly without support in this record. On the basis of this record, the Commission found that consumers have a price advantage. We think they have other advantages. Petitioners cannot show that they will be entitled to results more favorable to them under the method which they propound than under the method now being pursued by the Commission.

The suggested deferral of regulation by the Commission presents a question which has long been settled by this Court. As we have shown, it is nothing more than a request that the Court dictate the methods which the Commission should use and the order in which it should conduct its business. This Court long ago held that the Commission is ". . . not bound to the use of any single formula or combination of formulae in determining rates". *Federal Power Commission* v. *Natural Gas Pipeline Co.*, 315 U.S. 575, 586 (1942); *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944). The Court below properly

held that the selection of methods, procedures and order of business before the Commission is solely a matter for the Commission.

Clearly there is no occasion for this Court to consider that question again. Petitioners do not present reason for review merely by describing an old question in new words.

III. California's Contentions With Respect to the Section 4(e) Refund Cases Relate to Matters Having No Future Significance and Which Are Wholly Confined to Matters Peculiar to Phillips

Even more narrow in scope is that portion of the Commission's decision passing upon the suspended Section 4(e) increases. Here the Commission had before it rates which had been superseded by further increases. On the basis of its findings that the superseded rates had produced revenues less than the cost of service while they were in effect and that they were not unduly discriminatory or preferential, the Commission dismissed the Section 4(e) proceedings and relieved Phillips of all obligation to refund. The Court of Appeals reviewed this action in detail and concluded that this action fell well within the bounds of Commission discretion (Appendix A, No. 756, pages 10a-13a). Only California raises any question with regard to this portion of the Commission's decision (No. 755, pages 15-20).

The action which California desires this Court to take with respect to this portion of the Commission's decision is best described as obscure. California does not contend that the Commission could have ordered refunds on the basis of the record before it. It does not suggest that the Commission could or should order

refunds if the proceedings were remanded to the Commission. California's sole complaint appears to be that the Commission did not use the words "just and reasonable" with respect to these rates. Nothing in the language of the Act requires an express finding that rates are just and reasonable. In any event, it does not appear that the results would have been different if the Commission had taken the action demanded by California.

These rate increases are peculiar to Phillips. No precedents have been established which will affect or even become involved in future proceedings. Whatever the significance of the questions which Petitioners seek to raise concerning the Section 5(a) proceedings, it is apparent that the Commission's decision with respect to these Section 4(e) increases does not justify the grant of certiorari.

IV. The So-Called Spiral Escalation Clause Increases Are Limited in Scope and Have Little Future Effect

As a part of its decision with respect to the Section 4(e) increases, the Commission held that Phillips was entitled to file rate increases permitted by certain contractual provisions which California calls "spiral escalation clauses". These contract provisions permit Phillips (but only after a specified increase in a designated commodity index) to increase its rates in proportion to an increase by the purchaser from Phillips. The application of one of these provisions was upheld and enforced in *Phillips Petroleum Co.* v. *Federal Power Commission*, 227 F. 2d 470 (10th Cir., 1955, cert. den. *sub nom. Michigan Wisconsin Pipe Line Co.* v. *Phillips Petroleum Company*, 350 U.S. 1005).

The various contentions as to these clauses were carefully reviewed by both the Presiding Examiner and the Commission. Both the Examiner (R. 196-208) and the Commission (R. 326-328) emphasized that they treated these clauses as doing no more than providing the contractual consent which is required by this Court's decision in *United Gas Pipe Line Company* v. *Mobile Gas Service Corp.*, 350 U.S. 332 (1956). The increase in Docket No. G-10793 was allowed because the revenues resulting from these contract provisions were less than the cost of service; the increases in Docket Nos. G-10883 and G-11217 were given tentative approval on the same basis, subject to the amount of increase finally allowed to the affected pipeline company purchaser. Phillips was required to justify the increases under these clauses in the same manner as increases permitted by any other contract provisions.

These particular contract provisions are far more limited in application and much more restrictive upon the producer than the unrestricted increase provisions approved by this Court in *United Gas Pipe Line Co.* v. *Memphis Light, Gas & Water Div.*, 358 U.S. 103 (1958). California does not contend that the level of rates permitted by these contract provisions is excessive. Two of the three contracts containing these provisions have been amended to delete this type of provision (including the one affecting California). So far as is known, this type of contract provision is peculiar to Phillips and is not in general use by other producers.

There is nothing in these clauses or in the Commission's treatment of them which can be said to be of general interest. It is apparent that they have restricted future application even as to Phillips.

CONCLUSION

For the foregoing reasons it is respectfully submitted that these petitions for writs of certiorari should be denied.

Respectfully submitted,

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Section 4(e), 15 U.S.C. 717c(e)	2, 3, 4, 5, 7, 8, 10, 11, 12, 15, 21, 24
Section 5, 15 U.S.C. 717d	3
Section 5(a), 15 U.S.C. 717d(a)	2, 3, 8, 9, 10, 13, 16, 17, 25
Section 19(b), 15 U.S.C. 717r(b)	2
Federal Power Commission Regulations under the Natural Gas Act:	
Section 154.93, 18 C.F.R. 154.93, Order 232A, 26 F.R. 2850	21
Order 242, 27 F.R. 1356	21
Federal Power Commission Rules of Practice and Procedure:	
Section 2.56, 18 C.F.R. 2.56, General Policy Statement No. 61–1, 24 F.P.C. 818	6
Miscellaneous:	
Hearings, Committee on Appropriations, United States Senate, 87th Cong., 2d sess., on H.R. 11038, p. 106	14

In the Supreme Court of the United States

OCTOBER TERM, 1961

No. 754

STATE OF WISCONSIN AND PUBLIC SERVICE COMMISSION OF WISCONSIN, AND PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK, PETITIONERS

v.

FEDERAL POWER COMMISSION, PHILLIPS PETROLEUM CO.

No. 755

PEOPLE OF THE STATE OF CALIFORNIA AND PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, PETITIONERS

v.

FEDERAL POWER COMMISSION, PHILLIPS PETROLEUM CO.

No. 756

LONG ISLAND LIGHTING COMPANY, PHILADELPHIA ELECTRIC COMPANY, AND THE UNITED GAS IMPROVEMENT COMPANY, PETITIONERS

v.

FEDERAL POWER COMMISSION, PHILLIPS PETROLEUM CO.

ON PETITIONS FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR THE FEDERAL POWER COMMISSION IN OPPOSITION

OPINIONS BELOW

The opinion of the Court of Appeals for the District of Columbia Circuit (No. 754, Pet. App. A) is not

yet reported. The opinion and order of the Federal Power Commission (J. App. 251) are reported at 24 FPC 537, and the Commission's order on rehearing (J. App. 395) at 24 F.P.C. 1008. The decision of the presiding examiner, printed in part at J. App. 35, is reported at 24 F.P.C. 590.

JURISDICTION

The judgment of the Court of Appeals affirming the Commission's order was entered on November 30, 1961. The petitions for writs of certiorari were filed on February 28, 1962. This Court's jurisdiction is invoked under 28 U.S.C. 1254(1) and Section 19 (b) of the Natural Gas Act, 15 U.S.C. 717r(b).

QUESTIONS PRESENTED

1. Whether the Federal Power Commission erred in terminating consolidated proceedings under Section 4(e) of the Natural Gas Act involving refunds of increased rates collected during past periods, upon finding that the seller's cost of service exceeded its revenues.

2. Whether the Commission, in a proceeding under Section 5(a) of the Act to fix rates for the future, was required to use the rate-base, cost-of-service, method of ratemaking, despite its conclusion that this method was ill-adapted to producer regulation.

3. Whether California is aggrieved by the Commission's treatment of spiral escalation clauses involved in certain of the Section 4(e) proceedings.

STATUTES INVOLVED

The pertinent statutes, Section 4(e), 15 U.S.C. 717c(e) and Section 5(a), 15 U.S.C. 717d(a) of the Natural Gas Act, are set forth, in the Appendix, *infra*, pp. 24–26.

STATEMENT

The order sought to be reviewed is the culmination of a rate proceeding under Sections 4 and 5 of the Natural Gas Act, undertaken as the result of this Court's ruling in *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672, that the Federal Power Commission has jurisdiction over the wholesale rates of Phillips Petroleum Company, an independent producer of natural gas. Pursuant to that holding, the Commission on November 22, 1954, vacated its earlier termination of the proceedings and reinstituted its investigation of Phillips' rates under Section 5(a) of the Act. Section 5(a) empowers the Commission to fix rates for the future when it finds that the rates being charged are unjust or unreasonable.

Later, the Commission consolidated this Section 5(a) proceeding (No. G–1148) with twelve other proceedings under Section 4(e) of the Act. Section 4 (e) empowers the Commission to investigate and determine the justness and reasonableness of rates contained in new schedules filed with the Commission to change rates. When new schedules are filed, the Commission may suspend their operation for not more than five months and then permit them to take effect, subject to refund of any part of the new rate that may later be found not justified.

The twelve Section 4(e) proceedings here involved arose from the Commission's suspension of increased rates filed by Phillips. All of these increased rates[1] have been superseded in turn by higher rates which are the subject of other proceedings not now before the court. The total amount of increases involved in these present proceedings is about $5¼ million a year (J. App. 212). Because these rates have been superseded, they have no current or future applicability, but involve only the possibility of refunds, if found to be excessive.

The hearings in the consolidated proceedings covered a total of 82 days between June 26, 1956, and December 18, 1957. The parties, in addition to Phillips and the Commission staff, included 31 intervenors among whom were the present petitioners.

THE EXAMINER'S DECISION

A record of some 27,000 pages was compiled during the hearings and the examiner's decision, which was rendered on April 6, 1959, ran to well over 300 pages. This was the first time that the Commission had an opportunity to examine a major contested case in which an attempt was made to determine just and reasonable rates for an independent producer of natural gas by means of the rate-base, cost-of-service, method used in regulating electric utility and natural gas pipeline rates. The examiner, basing his conclusion mainly on the opinion of the Court of Appeals

[1] With one minor exception amounting to only $21,234 (J. App. 325).

in *City of Detroit* v. *Federal Power Commission*, 230 F. 2d 810 (C.A.D.C.), certiorari denied, 352 U.S. 829, and on *Bel Oil Corp.* v. *Federal Power Commission*, 255 F. 2d 548 (C.A. 5), certiorari denied, 358 U.S. 804, as well as on various Commission orders, decided that this method should be used (J. App. 50, *et seq.*). He found that Phillips' cost of service applicable to jurisdictional sales of natural gas was $57,280,218 (J. App. 214) for the test year 1954. The average unit cost of service he found to be 11.662 cents per Mcf. (J. App. 212.) The examiner then directed (J. App. 214) that Phillips submit rates which would produce total revenues equal to the jurisdictional cost of service as found by him.[2]

COMMISSION ACTION

On September 28, 1960, the Commission issued Opinion No. 338 (J. App. 251–341) covering all 13 of the proceedings involved in the consolidated hearing. In the Commission's view (J. App. 254), the principal question before it was whether the cost-of-service method should be applied in the regulation of producers. The Commission gave a negative answer to this question. The action resulting from the negative answer is the focus of petitioners' attack.

Drawing upon its experience in the instant proceedings and in other producer rate cases during the

[2] The effect of this use of cost of service would be to permit Phillips an aggregate rate increase totaling $14 million, over and above its jurisdictional revenues prior to the filing of Section 4(e) rate increases involved in the consolidated proceeding, or about $8¾ million higher than the $5¼ million increase reflected in Phillips' consolidated Sec. 4(e) dockets, *which the intervenors expressed their willingness to accept.* (J. App. 212).

preceding five years, the Commission held that the rate-base, cost-of-service, method of regulating public utilities is not a workable method of fixing rates for independent producers of natural gas (J. App. 256–269). It found that the ultimate solution of the manifold problems of producer regulation lies in the determination of fair prices for gas as a commodity, taking into account the reasonable financial requirements of the industry, but not the particular costs of each natural gas company. The Commission accordingly announced (J. App. 266) its purpose to fix prices in the various producing areas on a sectional, rather than a company, basis. In addition, it found that to fix Phillips' rates for 1960 and thereafter on the record before it—a record showing Phillips' 1954 cost of service—would be "a result without reason or justice" (J. App. 325).[3]

Simultaneously with its opinion in this case, the Commission promulgated its Statement of General Policy No. 61–1 (J. App. 343, *et seq.*),[4] which set forth prices for natural gas in various producing areas to be used as interim guides for purposes of suspending increased rate filings and certificating new sales.[5] The

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[3] Wisconsin and New York erroneously state (No. 754, Pet., p. 7, note 8) that Commission counsel abandoned this position at the oral argument.

[4] 24 F.P.C. 818; 18 C.F.R. 2.56.

[5] In one major producing area, Southern Louisiana, the "policy" price was subsequently reduced from 21.5¢ per Mcf *not* including state taxes to 21.25¢ *inclusive* of state taxes (amounting, in Louisiana, to 2.3¢ per Mcf). Fourth Amendment to Statement of General Policy, No. 61–1, October 31, 1961.

first two of a series of contemplated area rate hearings are now in progress, one covering the so-called Permian Basin (located in Texas and New Mexico), the other Southern Louisiana.

Although the Commission, in the instant case, declined to attempt to fix future rates on an individual company cost-of-service basis, it did consider Phillips' 1954 costs for purposes of determining whether refunds for past periods were to be ordered under Section 4(e). It arrived, after rehearing, at a total cost of service of $54,525,315 or 11.1009¢ per Mcf (J. App. 401), subject to adjustments for purchased gas costs, gathering taxes and royalties.[*] Finding that revenues from sales within the Commission's jurisdiction for the test year were $45,568,291, resulting in a deficit of almost $9 million, that the increases involved in the proceedings under consideration totaled approximately $5¼ million if allowed in full, and that any adjustments should be proportionate to all contract rates, the Commission concluded that no refund was due. Accordingly, it terminated ten of the consolidated Section 4(e) proceedings and discharged Phillips from any obligation to make refunds thereunder. The remaining two Section 4(e) cases, in which no final order has been entered, constitute two of the three proceedings in-

[*] This means that if Phillips' rates were to be raised so as to cover cost of service, these three items would increase to above the levels at which they are included in the $54,525,315 figure determined by the Commission. The Eastern Seaboard Companies, petitioners in No. 756, pointed out below that this suggests total revenue requirements, after adjustments, of $59,725,315, or a unit cost of about 12.16¢ per Mcf.

volving the spiral escalation clauses to which California refers (No. 755, Pet. 25). The Commission also terminated its Section 5(a) rate investigation proceeding.

THE DECISION BELOW

The Court of Appeals (one judge dissenting in part) affirmed the Commission's order. With respect to the proceedings under Section 4(e), covering rates for the past "locked in" period, the majority said (No. 754, Pet. A–11) "* * * [t]he only question of substance in respect to that period was whether refunds should be made." After pointing out that the Commission determined that Phillips' rates produced some $9 million a year in revenues less than the total cost of service for the test year,[7] the court held (*id.*, A–12–13) that the Commission acted reasonably in concluding that no refunds were due with respect to these past periods. The termination of the proceedings, the court concluded, logically followed from the Commission's "clear decision, after elaborate findings" on the issue of the necessity for refunds: "* * * it terminated them after deciding the basic and dispositive issue, and it entered an order on that decision."

As to the determination of rates for the future, the court held (*id.*, A–13–14) that the Commission was also justified in terminating the proceeding under Sec-

[7] We point out here, as we did below, that no petitioner claims that any of the rates is discriminatory or that there is any evidence in the record to support any rate-by-rate allocation of the cost of service. No party argues that rates should be fixed on any basis other than an over-all one.

tion 5(a). The Commission, the court observed, has inaugurated hearings under the "area-price" method so that it could "design suitable new standards for use in the regulation of producers when it found that the tools at hand were not suited to the purpose." The Commission, it stated, is not bound to apply the formulas for rate-making which were developed for regulating electric utility and natural gas pipeline rates to the essentially different facts and problems found in the untried field of producer regulation. "The Commission abandoned the pending 5(a) proceeding in which it had been endeavoring to establish rates for the future by methods it now deems inadequate. We see no reason why it should not have done so" (No. 754, Pet. App., pp. A–13–14).

Referring to the Commission's Statement of General Policy, the court stated that the adoption of area rates as an interim method of regulation, pending conclusion of the area rate hearings, represents a reasoned decision to abandon an unsatisfactory technique "in favor of a method it deems to be workable and just and reasonable. If that be so, instead of abandoning regulation it is making regulation effective" (*Id.*, A–18). The opinion pointed out that the way is open for consumer interests to challenge the results of the new method, and that, in the interim, new rates and increases will be subject to suspension and refund, so that the rights of customers will be fully protected.

Judge Fahy, dissenting in part, agreed that embarkation on the area rate method does not call for judicial intervention, certainly not at this time (*id.*, A–20). He was of the view, however, that although

it may be appropriate to use the area method in other cases, the Commission should have decided the Section 5(a) aspects of this case on the present record "supplemented as may be found to be reasonably necessary" (*id.*, A-22).

ARGUMENT

The crux of petitioners' contentions is that the Commission has deferred indefinitely the regulation of independent producers of natural gas, has abdicated its statutory duty to regulate, and has left consumers without the protection contemplated by the Natural Gas Act. This is not correct. As the court below correctly held, the terminated Section 4(e) proceedings "presented no questions as to rates to be charged"; and those proceedings were terminated only after the Commission decided "the basic and dispositive issue" whether refunds were due for the past "locked-in" periods (No. 754, Pet., p. A-11-12).

The termination of the Commission's proceeding under Section 5(a), which looked to the fixing of future rates, was also reasonable in light of the Commission's conclusion that the regulation of independent producers of natural gas required a new and different method from that employed in the regulation of electric utility and natural gas pipeline companies.[8] No one can seriously deny that

[8] Note, also, the Commission's finding, *supra*, p. 6, that to fix Phillips' future rates on the basis of the 1954 test year cost of service in the record before it would be "a result without reason or justice."

a regulatory agency has broad discretion in selecting an appropriate means or method of regulation. As all of the members of the court below agreed, the Commission's decision to embark upon a method of area pricing does not require, if indeed it would permit, judicial intervention at this time. In the interim, the Commission is employing the guide rates set forth in its Statement of General Policy in order to "hold the line" and protect consumers. As the Court of Appeals emphasized, no question as to the validity of these guide rates was before it (*id.*, A–16–17).

1. With respect to the refunds for the past periods involved in the consolidated proceedings under Section 4(e), the record shows that the cost of service exceeded revenues. As the court below pointed out (*id.*, A–11), the one substantive issue before the Commission in those proceedings was whether to order refunds; on that issue, it made a definitive decision, based upon elaborate findings. The court found it immaterial that the Commission did not precede its ultimate conclusion of "no refund" with an intermediate conclusion using the words "just and reasonable". The ultimate conclusion is fully warranted by the facts found from the record; yet petitioners seek review of the proceedings, not because the ultimate conclusion was erroneous, but because the intermediate conclusion was not stated in a particular verbal formula.

All of these proceedings were begun as the result of price increases filed between August 31, 1954, and September 10, 1956. Their termination was based on

the finding (J.A. 325–6) that cost of service for the test year 1954 exceeded revenues by substantially more than the amount of the proposed increases. Petitioners do not claim that the test year was unrepresentative, and the record affirmatively shows that 1956 costs were substantially the same as those for 1954 (J.A. 272). The Commission was thus clearly warranted in deciding that no refunds should be ordered with respect to the proceedings here involved, which comprised all of Phillips' increased rate proceedings pending on December 14, 1956, the date of the last consolidation order. Furthermore, all of these increases have since been superseded by others and the decision here is not of any future significance.

It is not true that the Commission relied on its knowledge of increased costs in years subsequent to the test year for the purpose of terminating these proceedings under Section 4(e) (see Pet. No. 754, p. 6). The Commission's observation as to post-test-year costs and revenues (R. 329) was merely a basis for suggesting that it "may be reasonable" to terminate some of the *other* proceedings, relating to post-1956 increases not involved in this case, and for inviting "the filing of motions to this effect." As the Commission observed, "All parties to these proceedings would, of course, have opportunity to object to such motions." It is erroneous to suggest that the Commission has approved any rates except those before it in this case, or that it approved even these rates (relating only to past periods) on any basis except the very cost-of-service method for which petitioners contend.

2. The Commission, in explaining its termination of the proceeding under section 5(a), gave cogent reasons for declining to fix future rates on an individual company cost-of-service basis, and its reasons were not challenged. It observed, first, that the cost-of-service method, with its emphasis on return on investment, penalizes the efficient or fortunate producer and unduly rewards the inefficient or unfortunate one. Unless a producer has bought developed acreage at a fair price, there is no meaningful relationship between investment and return. He who takes the largest development risk usually pays less for his rights, and hence has a smaller investment, than those who follow him.

The Commission stated further that difficulties of cost allocation (as between jointly produced gas and oil) and the fact that unit costs of gas must be calculated from highly variable and often inaccurate reserve estimates are factors throwing doubt on the validity or usefulness of the cost-of-service method. It observed that the individual-company-cost approach to rates encourages leasing to the higher-cost producers because the lessors (*i.e.*, the royalty owners) receive a percentage of the price. It pointed out that this method would also require it to hold repeated rate cases, often of great size and complexity, for each producer.

An alternative to the rate base method is the determination of fair prices for gas based on the reasonable financial requirements of the industry, rather than by reference to the rate base and expenses of each company. This method does involve the use of

typical or composite cost data, but only as a part of the body of economic information necessary for intelligent regulation of the industry. The "ultimate objective will be to set prices in all producing areas which will be adequate to maintain the gas supplies needed by the consumers of the nation, but at prices that are no higher than are necessary to accomplish that purpose" (J.A. 266).[9]

Instead of an "indefinite deferral" of the fixing of just and reasonable rates, there are now in progress proceedings to fix such rates in two of the country's major producing areas, which are also two of Phillips' largest producing areas. Similar proceedings in other areas will follow. As the court below observed, to adopt a more manageable technique of control over prices is not to abandon regulation but to make it more effective.

In insisting that the Commission use individual company cost of service as a basis for future rates, petitioners are asking this Court to do what it has con-

[9] Although the membership of the Commission has changed completely since this case was decided at the administrative level, the Commission has adhered to the view that the area approach should be pursued. "If we can set a path and dispose of these producer rate cases in these areawide cases, we will have achieved something that the industry is looking for and also something the public is looking for, because these are the increases that go up the line to the pipelines and to the distributing companies and are paid by the consumers. Your whole regulatory pattern is thrown into chaos when these producer rates are triggered and go up from time to time." Testimony of Federal Power Commission Chairman Joseph C. Swidler, Hearings, Committee on Appropriations, United States Senate, 87th Cong., 2d sess., on H.R. 11038, p. 106.

sistently refused to do in the past—to fasten a particular method of rate-making upon an administrative body. *Federal Power Commission* v. *Natural Gas Pipeline Co.*, 315 U.S. 575, 586; *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591, 602. See, also, *Bel Oil Corp.* v. *Federal Power Commission*, 255 F. 2d 548 (C.A. 5), certiorari denied, 358 U.S. 804, in which the Fifth Circuit pointed out that the problems inherent in the regulation of independent natural gas producers are unique and require the development of new tests and techniques.[10]

3. When the Commission decided that the area method, rather than individual company cost of service, was the appropriate way to fix Phillips' rates, it was confronted with the question of how to prevent a hiatus in regulation during the pendency of the area rate hearings. All the increased rates in the Section 4(e) proceedings in this case were filed before September 11, 1956, and were found, on the basis of a full record, to result in a rate level below cost of service (see *supra*, pp. 11–12). Petitioners suggest that Phillips' subsequently filed increases (which are involved in other Section 4(e) proceedings) may have raised revenues above cost of service. They argue that the Commission could determine whether that is so by reopening the proceedings and obtaining

[10] In other fields as well, this Court has held that the choice of the method whereby statutory policy is to be implemented is peculiarly a matter for administrative competence. *Phelps Dodge Corp.* v. *National Labor Relations Board*, 313 U.S. 177; *American Power & Light Co.* v. *Securities Exchange Commission*, 329 U.S. 90.

cost-of-service data for a more recent test year; that if it then found that cost of service did not justify the post-1956 increases, it could prescribe rates on that basis (notwithstanding its dissatisfaction with the cost-of-service approach); that this would result in a quicker decision than the use of the area method; and that therefore it is obligatory upon the Commission to continue to apply a cost-of-service method to Phillips.

The Commission's conclusion was that, instead of reopening the proceedings to attempt to make another determination of cost of service for a new test year, it should use the area method both for fixing Phillips' future rates under Section 5(a) and for determining refunds of the increased rates which had not been consolidated in the present proceedings. The Commission, while it pursues this task, is keeping Phillips' rates under control. Its Statement of Policy clearly shows how this control will be exercised as to all companies, including Phillips (see *supra*, pp. 6–7). To assert, as do Wisconsin [11] and New York, that the termination of the Section 5(a) proceeding represents "an indefinite deferral of exercise of jurisdiction" is erroneous.

Fully realizing the importance of interim controls while it is going forward with the area rate proceedings, the Commission announced in its Statement of General Policy that it would be guided by the rates listed in the Statement, in (1) conditioning proposed initial prices in certificate proceedings, and (2) exer-

[11] In the court below, Wisconsin did not challenge the termination of the proceeding under Section 5(a).

cising its power to suspend proposed rate increases.

The Statement contains two sets of prices, one of which applies to rates for initial service and the other to proposed increases in rates for service already established. In most instances, the latter are considerably below the former (J.A. 348). It is this lower set of prices which guides the Commission's action in relation to proposed changes in the price of any gas now flowing.

The higher set will guide it in fixing the initial price for "new" gas. But the price to be fixed in future certificates is not an issue in the instant case and would not be decided if the Commission were compelled to proceed with the Section 5(a) case against Phillips. It is therefore irrelevant to argue (No. 754, Pet., pp. 15–20) that these prices are comparable to the highest current prices.[12] Petitioners can litigate the grant of new certificates in appropriate cases if they are aggrieved by too high an initial price, as *Atlantic Refining Co.* v. *Public Service Commission of New York*, 360 U.S. 378 (the *Catco* case), amply demonstrates.[13]

The other prices in the Statement of General Policy, those governing rate increases, are markedly below

[12] Also, we dispute the factual premises of the argument. The Commission set forth (J.A. 345) the factors it took into account in arriving at the levels set forth in the Statement of General Policy. Existing and historical price structure constituted only one factor among many. See, also, note 5, p. 6 *supra*.

[13] Upon remand to the Commission, the "Catco" initial price was reduced from 21.4¢ to 18.5¢ and refunds of the difference were ordered from the date of initial delivery. Opinion No. 351, January 22, 1962 (not yet officially reported).

current levels in virtually every case. Nowhere (except in West Virginia, where Phillips has no production) do they exceed 14¢ (J. App. 348).[14] When it is remembered that Phillips' revenue requirements *in 1954* were 12.16¢ (*supra*, p. 7, n. 6), there would seem to be no doubt that prices ranging from 14¢ down to 11¢ protect the public during the interim period. The largest part of Phillips' sales in the test year were in the Permian Basin and Oklahoma Panhandle areas (J. App. 15), where the price set forth in the Policy Statement is 11¢ (J. App. 348). The suggestion that the Commission is about to let prices run wild until area prices are fixed is entirely without foundation.

The total situation with respect to Phillips's rates presents an excellent example of the Commission's vigorous protection of the consumer pending the establishment of a satisfactory method of fixing producer rates. No less than 79% of the volume of gas which Phillips sold in 1960 was sold under rate schedules having refund conditions attached. Over 82% of its total dollar revenues came from these schedules.[15]

The reason those schedules have refund conditions attached to them is that when they were filed (as rate

[14] In four districts in Texas, the Commission, by a Policy Statement amendment, permits increases up to 14.6¢ and 15¢ in certain exceptional circumstances. The increases are permitted contingent upon the elimination of favored-nation provisions and price redetermination provisions from the rate schedules and upon the elimination or limitation of price escalation clauses. Only a very small portion of Phillips' output is in these areas.

[15] Computed from figures shown in Federal Power Commission Form 301 filed by Phillips for 1960 (latest available).

increases superseding the previously established schedules) the Commission promptly suspended them. The schedules which were not suspended and hence do not have a refund obligation produced revenues of only ~~$16,248,005~~ 16,421,282 out of Phillips' total 1960 revenues of $90,859,248. The amount of gas sold under those schedules was 133,266,144 Mcf.[16] Thus the average price of the gas sold free of refund obligation *in 1960* was only ~~12.2¢~~ 12.3¢ per Mcf—a figure approximately equal to the *1954* revenue requirements per Mcf on a cost-of-service basis (see *supra*, pp. 7, 18).

4. Petitioners argue that the opinion below is inconsistent with the same court's decision in *City of Detroit* v. *Federal Power Commission*, 230 F. 2d 810 (C.A.D.C.), certiorari denied, 352 U.S. 829, in that it permits reliance on "fair field prices" in determining just and reasonable rates.[17] Patently, there is no basis for this contention.

The Commission has not proposed to use "fair field prices" for any purpose. The "policy prices" which guide its exercise of the power to suspend rates are, indeed, far below current prices. They serve to protect the consumer (through imposition of the refund obligation which flows from suspension) pending a

[16] *Id.*

[17] The holding of the *City of Detroit* case was that *a pipeline* which owns producing wells may not include the "fair field price" of the gas from those wells as an element of its actual cost of service. If there were inconsistency (which we dispute), there would still be no intercircuit conflict.

final determination of just and reasonable rates in area proceedings. Nor is there any basis for an inference that these final determinations will be governed by field prices. In any event, there was no question before the Court of Appeals concerning the computation of any guide rate set by the Commission;[18] and, obviously, there can be no valid challenge to the basis of area rates not yet determined or established.

5. California advances a separate contention relating to spiral escalation clauses, *i.e.*, clauses which permit a producer to raise its price to a pipeline when an increase in a price index or an increase in the pipeline's resale rates has taken place.[19] In the court below, Wisconsin and California contended that the Commission's order should be set aside because it does not hold such clauses to be void as a matter of law. Wisconsin abandons that contention here, but California urges it as a reason for granting certiorari. Contracts containing spiral escalation clauses are involved in three of the thirteen proceedings covered

[18] The court below stated: "Let us emphasize that we do not have before us at this time the question whether any rate set by the Commission as a guide rate falls within the area of reasonable computation. That question is emphatically left open by the Commission, and by us, for consideration when some one or more of the selected guide rates is attacked, by a producer, a customer, or a consumer." (No. 754, A–16–17).

[19] The terms of the contracts which California attacks are not in the record before this Court. California is evidently asking for a general opinion on all spiral escalation clauses, without having considered it necessary to bring any one of them to the Court's attention.

by the Commission's order. Two of those three proceedings were not terminated because there remains for decision the question whether the escalation clauses had been triggered according to their terms. Since in those proceedings no final order has been entered, the court below correctly held that the attack was premature. California's complaint thus comes down to one proceeding, Docket G–10793, a Section 4(e) proceeding in which the proposed rate, giving effect to the spiral escalation clause, is 10.858¢.[20] The rate involved is a rate charged to Michigan Wisconsin Pipe Line Co., and although Wisconsin, which has abandoned the point, is affected by the rate, California is not.

The Commission itself last year adopted a regulation[21] providing that spiral escalation clauses in contracts tendered for filing as rate schedules after April 3, 1961, "shall be inoperative and of no effect at law." Thus, the Commission prohibited the filing of increases based on such clauses as being against the public interest. It has now prohibited the filing, after April 2, 1962, of contracts containing such clauses. To strike them from contracts already filed, however, might deprive the producer of a part of the consideration for which he agreed to sell his gas.

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[20] This rate is less than Phillips' cost of service. It appears in Wisconsin's brief below, though not in the record designated in this Court.

[21] Order No. 232A, 26 F.R. 2850, amending Section 154.93 of its General Rules and Regulations, 18 C.F.R. 154.93. This has been further amended by Order 242, 27 F.R. 1356, which prohibits the filing on or after April 2, 1962, of rate schedules containing spiral escalation clauses.

Assuming, *arguendo,* that this could be done, the legal and regulatory problems resulting from it might cause material harm to the public—harm that might well exceed the injurious effects of the escalation provisions themselves. For instance, if the voiding of such a provision made the entire contract voidable, the producer could then change rates at will, unhampered by contractual limitations, and file increases whenever it chose. In that way, the uncertainty inherent in spiral escalation clauses would be compounded, see *Southwestern Sugar & Molasses Co., Inc.* v. *River Terminals Corp.,* 360 U.S. 411. Here, there is no question of allowing spiral escalation clauses to permit Phillips to charge whatever the clauses may call for. The most any such clause can do is to permit a new filing, and when a filing is made it becomes subject to Commission scrutiny, *i.e.,* to exercise of the suspension power and the fixing of a just and reasonable rate.

The question at bar (if California can properly raise it) is not whether rates should be allowed to increase automatically under spiral escalation clauses, but merely whether the clause involved in one of the thirteen proceedings represents a valid consent by the customer to an increased-rate filing by Phillips, subject to all the safeguards provided by the Act. This Court has previously refused to review a case in which a court of appeals declined to treat a spiral escalation clause as a nullity (*Phillips Petroleum Co.* v. *Federal Power Commission,* 227 F. 2d 470 (C.A. 10), certiorari denied, *sub nom. Michigan Wisconsin Pipeline Co.* v. *Phillips Petroleum Co.,* 350 U.S.

1005), and has sustained a contractual arrangement under which there was no limit whatever on the seller's right to file for increases (*United Gas Pipe Line Co.* v. *Memphis Light, Gas & Water Division*, 358 U.S. 103). Clearly, California's argument on this point is without merit.

CONCLUSION

For the foregoing reasons the petitions for writs of certiorari should be denied.

Respectfully submitted.

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APRIL 1962.

APPENDIX

The Natural Gas Act, Section 4(e), 15 U.S.C. 717c (e) and Section 5(a), 15 U.S.C. 717d(a), provides as follows:

> SEC. 4. (e) Whenever any such new schedule is filed the Commission shall have authority, either upon complaint of any State, municipality, or State commission, or upon its own initiative without complaint, at once, and if it so orders, without answer or formal pleading by the natural-gas company, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the natural-gas company affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect: *Provided,* That the Commission shall not have authority to suspend the rate, charge, classification, or service for the sale of natural gas for resale for industrial use only; and after full hearings, either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made at the expiration of the suspension period, on motion of the natural-gas company making the filing, the proposd change of rate, charge, classification, or service shall go into effect.

Where increased rates or charges are thus made effective, the Commission may, by order, require the natural-gas company to furnish a bond, to be approved by the Commission, to refund any amounts ordered by the Commission, to keep accurate accounts in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts were paid, and, upon completion of the hearing and decision, to order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the natural-gas company, and the Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible. [52 Stat. 822 (1938); 15 U.S.C. § 717c]

SEC. 5. (a) Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: *Provided, however,* That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural gas company on file with the Commission, unless such

increase is in accordance with a new schedule filed by such natural gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates.

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No. 74

IN THE

Supreme Court of the United States

OCTOBER TERM, 1961

LONG ISLAND LIGHTING COMPANY, PHILADELPHIA ELECTRIC COMPANY, and THE UNITED GAS IMPROVEMENT COMPANY, *Petitioners*

v.

FEDERAL POWER COMMISSION, PHILLIPS PETROLEUM CO., *Respondents*

On Petition for Writs of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

REPLY MEMORANDUM OF LONG ISLAND LIGHTING COMPANY, PHILADELPHIA ELECTRIC COMPANY, AND THE UNITED GAS IMPROVEMENT COMPANY

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1961

No. 756

LONG ISLAND LIGHTING COMPANY, PHILADELPHIA ELECTRIC COMPANY, and THE UNITED GAS IMPROVEMENT COMPANY, *Petitioners*

v.

FEDERAL POWER COMMISSION, PHILLIPS PETROLEUM CO., *Respondents*

On Petition for Writs of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

---

REPLY MEMORANDUM OF LONG ISLAND LIGHTING COMPANY, PHILADELPHIA ELECTRIC COMPANY, AND THE UNITED GAS IMPROVEMENT COMPANY

This cause, as the court below recognizes (Pet. App. 2a), involves "major problems of general application." The decision below abets collection by producers for the indefinite future of countless millions of dollars in

rates which exceed area levels set by Respondent (R. 348) *without any possibility of refund*. It also indefinitely prolongs collection subject to refund of $168,000,000[1] annually, in rates almost all of which exceed existing area ceilings, and most of which may well not, for practical reasons, be actually recoverable by consumers (*infra*, p. 5).

Both Respondent[2] (R. 256-269) and the court below (Pet. App. 5a-10a) recognize that Respondent, in its opinion and order on remand from this Court's *Phillips* decision, has charted the future course of natural gas producer regulation. Respondent's brief in opposition to certiorari, in sharp contrast, now seeks to minimize the importance of the *Phillips* decision by treating it as merely a disposition of the particular rates of Phillips Petroleum Company for a limited period ending in 1959. Respondent has admitted, however, that in deciding to defer application of Section 5(a) of the Natural Gas Act to Phillips' existing and future rates, pending completion of area proceedings, it has at the same time decided similarly to defer application of Section 5(a) to the existing and future rates of other natural gas companies including those whose rate proceedings are virtually completed (Br. 13-14, 16); and its decision in this regard has been affirmed by the Court of Appeals.

This decision is before the Court for possible review. Petitioners seek review not to alter the main directions of the new regulatory policy, as Respondents

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[1] FPC 1961 Annual Report, p. 79.

[2] Reference hereafter is to Respondent Federal Power Commission.

allege, but rather to assure effective *interim* protection for gas consumers.

1. Respondent (Br. 15) seeks to minimize the possibility of injury to the consuming public as a result of its decision to defer testing of existing rates pursuant to Section 5 of the Natural Gas Act pending completion of the area proceedings. Significantly, it does not discuss, much less answer, petitioners' main point, which is that *current* unregulated prices, which cannot be tested except prospectively under Section 5(a), can cause irreparable consumer loss pending the development of a viable regulatory method. Rather, focusing on *Phillips* alone, Respondent argues (Br. 18-19) that a substantial portion of the revenues collected under Phillips' existing rates is subject to retroactive adjustment pursuant to Section 4(e) of the Act and that, therefore, the Commission's refund powers provide adequate protection during the interim period.

Respondent's discussion (Br. 18-19) of Phillips' current refundable revenues is misleading. Phillips' current rates are not as Respondent seems to suggest (Br. 18-19) in the 14-cent to 11-cent range, but in many cases exceed 20 cents per Mcf. See Appendix B to petitioners' application for rehearing (R. 387-389). Further, Respondent's assertion that 82% of Phillips' current revenues are subject to refund would undoubtedly be disputed by Phillips, whose 1960 FPC Form 301 showed only 22.7% subject to refund. But whether the percentage is 82 or 22, Respondent's deferral of *current* rate regulation hardly constitutes "keeping Phillips' rates under control" (Respondent's Br., p. 16). With rare exceptions, the prices now being paid Phillips are exactly as they would have been had there been no "statement of general policy." Phillips, in the

years 1959 and thereafter, has made a substantial number of sales at prices in excess of 20 cents per Mcf which have been certificated by the Commission without provision for refund (R. 387-389). Thus, the fact that substantial volumes of Phillips' lower priced gas is sold under refundable rates is no substitute for the protection against these high priced sales which can be attained only under Section 5(a) of the Act. As Appendix B, *infra*, p. 13, demonstrates, only 9% of South Louisiana gas now flows at prices below 16 cents per Mcf.

Respondent's contentions also overlook the fact, as we shall show (*infra*, pp. 5-6), that the current and non-refundable revenues of producers generally have increased sharply since 1954.

Furthermore, Respondent has recently recognized, in contrast to its position here, in successfully seeking certiorari in the Court, that the bare existence of a theoretical power to refund is no substitute for expeditious and effective regulation of current prices.

> "The decision [for which review is sought] seems to rest largely on the erroneous view that consumers are fully protected, albeit they continue to pay excessive rates, by the pipeline's ultimate obligation to refund the excess charges with interest. But, as the Commission has recognized, the protection afforded by refund provisions is by no means complete. Ours is a mobile society; those consumers of natural gas who pay excessive rates in a given area today are scattered as the months go by. For the ordinary consumer, even if he does not move, a daily increase in his cost of living is not offset by the prospect of receiving a lump sum sometime in the future. The Court has encountered this problem in the cases dealing with the disposition of funds impounded as a result of

judicial stays of Commission rate reduction orders. Moreover, the inflationary impact of present day high rates is scarcely relieved by the possibility of refunds at an indeterminate date in the future." *F.P.C. v. Tennessee Gas Transmission Co., et al., cert. granted*, 30 U.S.L. Week 3229 (No. 591) Jan. 22, 1961, Petition of Federal Power Commission for Writ of Certiorari, pp. 10-11. [Footnotes and citations omitted]

Moreover, the Court will recognize that when contested prices are collected over a long period of time, the expectations of people making business decisions within the industry and of the investing public are bound to be influenced by the price being paid, even though there be a footnote—and the notation is all too often omitted—that the collection of such price is subject to dispute. More important, consumers are prejudiced in seeking to recover refunds by the sheer volume of the sums involved, and the inevitable cries of hardship which will arise if such large sums, collected over the greater part of a decade, must be surrendered with interest.

More important, Respondent's refund powers, even if effective, can reach only a part of the current sharply increased rates now being paid by consumers. Of the total 1960 revenues received by the 13 major producers whose Section 5(a) rate cases are near completion, roughly 83 per cent is now being collected not subject to any refund obligation (Appendix C, Wisconsin-New York Petition). A very substantial percentage of this non-refundable revenue is derived from sales and price levels in the 20 to 24 cent range which exceed the applicable Commission area price levels (R. 348), or which represent sharp increases over historical price levels in the particular area (see Appendix D, Wis-

consin-New York Petition). Such sharply increased prices are *prima facie* suspect and in all probability unlawful.

Taking South Louisiana as the most important example, 1960 jurisdictional sales by the foregoing 13 producers at prices in excess of 21.25 cents per Mcf (Respondent's current area "ceiling") aggregate approximately 436,000,000 Mcf, or 38 per cent, of total South Louisiana sales above this price level which amounted to 1,128,000,000 Mcf. Approximately 134,000,000 Mcf of this 436,000,000 Mcf (i.e., some 31 per cent) was sold at rates in excess of 21.25 cents per Mcf which are probably not subject to refund (Appendix A, *infra*, p. 12).[3] It should also be noted, as previously stated, that only 9 per cent of the *total* 1960 sales volume in South Louisiana was sold at prices less than 16 cents per Mcf, which is close to the Commission's current South Louisiana "old gas" ceiling of 15.75 cents (R. 348; Appendix B, *infra*, p. 13).

While it is impossible, of course, to compute the exact amount of total jurisdictional revenues which are probably being collected unlawfully and without possibility of refunds, there can be no doubt that the amounts are of enormous magnitude.

Thus, the Commission's deferral of regulation under Section 5(a), if permitted to continue, will result in a

[3] The condition of F.P.C. records make it impossible to do more than estimate the exact jurisdictional volumes being sold not subject to refund, since the only available data are derived from the pipeline "Form 2" reports which do not invariably segregate jurisdictional and intrastate sales. Hence, the foregoing figures (and those in Appendix A, *infra*, p. 12) may overstate the jurisdictional revenues not subject to refund, and must be taken as approximations. However, the actual volumes not subject to refund would be of the same order of magnitude.

significant and irretrievable increase in basic fuel costs borne by the ultimate consumer, wholly without consideration as to whether such an increase is consistent with the standards of the Natural Gas Act. Such an abdication of regulatory responsibility, unexplained and unjustified in Respondent's brief, warrants review by this Court.

2. Respondent (Br. 19-20) argues that there is no conflict of decision with *City of Detroit* and other cases holding that field prices alone cannot be used as a basis for testing "just and reasonable" rates, since Respondent does not intend to use the field prices embodied in its "new gas" SGP61-1 area price levels to set just and reasonable rates (Br. 20). The court below held, however (Pet. App. 17a), that the SGP61-1 initial or new gas rate levels could be treated as just and reasonable levels applicable to existing, not merely initial, rates pursuant to Sections 4 and 5(a) of the Act. This conclusion is not dictum, but a necessary premise for the court's holding that Respondent will be able to protect consumers under Section 5(a) simply by applying these SGP61-1 rate levels, without continuance or completion of individual company Section 5(a) cases. Thus, the court expressly relies on this conclusion in holding that Respondent did not abuse its discretion in failing to determine Phillips' just and reasonable current and future rates (Pet. App. 18a). Inasmuch as Respondent obviously cannot apply the SGP61-1 levels under Sections 4(e) and 5(a), absent hearing, unless those levels are just and reasonable, the opinion below is logically consistent only if interpreted as holding that the SGP61-1 levels are just and reasonable rates for each area in question.

Appendix D of the Wisconsin-New York Petition demonstrates that these rate levels are merely the highest previously certificated but untested price in each area, i.e., that they represent one limited version of the "fair field price" standard of regulation.[4] Thus, the holding that these levels are just and reasonable conflicts squarely with the *City of Detroit* decision and other Court of Appeals' decisions (discussed at pp. 17-20, Wisconsin-New York Petition) holding that unregulated field prices alone are not a sufficient basis for a Commission determination of justness and reasonableness under the Natural Gas Act. The conflict is clearly one between the circuits, despite Respondent's contrary suggestion (Br. 19, fn. 17). If the court below is correct in its conclusion, then the six decisions cited at p. 18 of the Wisconsin-New York Petition are wrong on this point. The conflict is inescapable, and is of major importance in federal regulation of the natural gas industry, and should be resolved by this Court.

3. Respondent (Br. 11-12) also misconceives the actual significance of its action in terminating Phillips' Section 4(e) proceedings applicable to rates in effect from 1955 through 1959 on the basis of Phillips' 1954 test year costs. Respondent (Br. 11) correctly points out that it found that the Section 4(e) increases were justified based on test year 1954 costs, since the increased rates fell short of making up Phillips' revenue deficiency during that year. What Respondent overlooks, however, is the fact that certain of these increased rate proceedings continued in effect through the year 1959 (Pet. App. 13a-14a); and, thus, in terminating all

[4] Respondent, while disputing (Br. 17, fn. 12) this assertion, makes no attempt to support its position by citation or factual references. See Appendix D, Wisconsin-New York Petition.

of the Section 4(e) proceedings and finding the Section 4(e) increases just and reasonable, the Commission was, in effect, sanctioning part of Phillips' 1959 rates on the basis of its 1954 costs. There is, of course, nothing in the record to show whether or not Phillips' unit revenues in 1959, which had increased 37 per cent over its 1954 unit revenues,[5] were just and reasonable, since the Commission had refused despite petitioners' request (R. 381) to obtain up-to-date 1959 costs.[6]

The Commission found (R. 325) that to fix Phillips' rates in 1960 on a record including only 1954 costs would be "a result without reason or justice." Petitioners heartily agree, adding only that the Commission's action in fixing Phillips' 1959 rates included in the consolidated Section 4(e) dockets on the basis of its 1954 costs is similarly "a result without reason or justice." Respondent's brief does not address itself to this point, presumably because it has no answer to it.

CONCLUSION

Petitioners do not, as Respondent claims (Br. 14-15), seek to force a particular regulatory method upon it. Petitioners support the "area approach" to producer regulation as a long-range solution to many of the problems of producer rate making. Petitioners do urge that there must be *interim* regulation based on Section 5(a) pending the success of the area proceed-

[5] 1954 data from Respondent's opinion; 1959 data from F.P.C. staff report on 1960 producer sales issued October, 1960.

[6] Respondent's discussion of the point is at R. 324-326, where it makes the crucial finding that the consolidated Section 4(e) rates "have produced revenues less than Phillips' cost of service during the periods they were in effect," (i.e., 1955-59). There is no evidence in the record supporting this finding, and Respondent cites none.

ings. As the dissent below recognizes (Pet. App. 20a-23a), the almost completed individual major producer cases offer the only practical means at present to achieve that interim regulation, and to carry out the policy of the Natural Gas Act.[7]

[7] While Respondent (Br. 13) recites the difficulty of an individual company approach to regulation, the Commission's Examiners have continued to decide major company cases at an accelerating rate, applying the method and principles employed by the Commission in its Opinion here. Without commenting on the Commission's "parade of difficulties" (R. 258-266), it should be evident that most of them refer to the problems of regulating small producers which are essentially small-scale explorers with great variations in costs and returns. However, there is nothing in the Natural Gas Act which compels the Commission to utilize the same method in regulating Phillips or other producers of comparable size and in regulating the approximately 6,000 small-scale gas explorers. As the dissenting judge herein points out (Pet. App. 21a, 23a), it is difficult for the Commission to argue that the individual company approach cannot be used as an interim device for controlling major producer rates, inasmuch as it has done exactly that in this case, as have its Examiners in a number of major company cases. Decision, *Tidewater Oil Co.*, Docket No. G-13310, *et al*, September 14, 1961; Decision *Hunt Oil Co.*, Docket No. G-9065, *et al.*, October 2, 1961; Decision, *Amerada Petroleum Co.*, Docket No. G-9385, *et al.*, April 9, 1962.

For these reasons, as well as those set forth in the petition in this case and in No. 754, this term, it is respectfully submitted that this petition for a writ of certiorari should be granted.

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APPENDIX A

1960 South Louisiana Jurisdictional Sales by 13 Producers at Prices Above 21.25 Cents

(Mcf at 15.025 Psia)

Producer	Total	Estimated Not Subject to Refund[1]
Amerada	4,024,376	99,837
Cities Service	6,661,308	1,042,637
Continental	82,402,402	2,921,393
Gulf	27,100,259	5,646,958
Hunt Oil	8,892,149	26,199
Ohio	7,071,256	0
Phillips	42,697,022	23,950,166
Shell	132,882,136	14,009,648
Sohio	11,926,080	978,865
Sun	34,002,685	18,549,843
Texaco	50,591,625	47,766,413
Tidewater	14,011,377	11,382,513
Union Producing	13,806,581	8,006,985
Total 13 Producers	436,069,256	134,381,457
Total All Producers	1,128,327,240	

Source: F.P.C. Form 2 Reports, Year ended December 31, 1960.

[1] Sales not subject to refund include certain sales which are not identified as to their interstate or intrastate nature; and rate schedules under which no actual collections were made subject to refund.

APPENDIX B

Distribution by Price Class of Average Prices Paid for Natural Gas by Interstate Pipelines in South Louisiana in 1960

Price Class	1960 Purchases Mcf (15.025 Psia)	Per Cent of Total
6.00- 6.99	2,221,736	0.11%
7.00- 7.99	666,642	0.03
8.00- 8.99	23,309,679	1.14
9.00- 9.99	38,811,248	1.90
10.00-10.99	35,714,274	1.75
11.00-11.99	40,272,392	1.97
12.00-12.99	2,677,253	0.13
13.00-13.99	495,768	0.02
14.00-14.99	2,670,530	0.13
15.00-15.99	37,982,695	1.86
16.00-16.99	5,263,682	0.26
17.00-17.99	42,823,701	2.09
18.00-18.99	180,441,826	8.83
19.00-19.99	158,926,371	7.77
20.00-20.99	252,391,713	12.35
21.00-21.99	337,183,253[1]	16.49
22.00-22.99	402,139,026	19.67
23.00-23.99	423,440,530	20.71
24.00-24.99	56,830,783	2.78
Total	2,044,263,102	100.00%
Average Price 20.57¢ Purchases Above 21.25¢	1,128,327,240	55.19%

Source: F.P.C. Form 2 Reports, Year ended December 31, 1960.

[1] 245,916,901 Mcf in this price class sold for more than 21.25 cents, the FPC "new gas" ceiling.

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IN THE

Supreme Court of the United States

OCTOBER TERM 1961

No. 72

STATE OF WISCONSIN and PUBLIC SERVICE COMMISSION OF WISCONSIN, and

PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK,
Petitioners,

v.

FEDERAL POWER COMMISSION,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT.

MEMORANDUM IN REPLY TO RESPONDENT'S BRIEFS IN OPPOSITION.

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Dated: May 3, 1962.

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IN THE

Supreme Court of the United States

OCTOBER TERM 1961.

No. 754.

STATE OF WISCONSIN and PUBLIC SERVICE COMMISSION OF WISCONSIN, and
PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK,
Petitioners,

v.

FEDERAL POWER COMMISSION and
PHILLIPS PETROLEUM COMPANY,
Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT.

MEMORANDUM IN REPLY TO RESPONDENTS' BRIEFS IN OPPOSITION.

In our petition seeking a writ of certiorari, we urged that this Court should grant review because of the importance of the case and its enormous impact on the ultimate consumer. The case was important, we asserted, because the court below had endorsed a Federal Power Commission determination to *abandon* the admittedly lawful cost method of regulation (which, at the point of its abandonment, had not yet been tried for producers, but was then ready for application) in order to pursue an area-price method, which would not become effective for from four to fourteen years. It was our contention that until the area price method

becomes effective, the Commission should take advantage of its own and other parties' enormous investment in the traditional individual-company-cost method of regulation to fix the rates of those major producers which, like Phillips, had already gone through hearing proceedings and briefing. It was our further contention that, during the four- to fourteen-year period while proper area prices were being evolved and determined, adequate consumer protection would not be provided by the Commission's promise to use its newly-announced interim area price levels to "test" the propriety of increased rates for old sales and initial prices for new sales.

The Federal Power Commission's Brief in Opposition in no way controverts our allegation that the issue involved is of crucial importance in the administration of the Natural Gas Act. Neither does it expressly controvert our allegation that the decision below will have an enormous impact on the consumer. Rather the brief makes three major points:[1]

1. That the Commission determination not to require refunds of the rate increases collected between 1955 and 1959 was proper. (FPC Brief, pp. 11-12.)

2. That during the long period until area pricing becomes effective, use of the rate levels set forth in the Commission's Statement of General Policy (the SGP levels) will "hold the line" and thereby protect the consumer. (FPC Brief, pp. 13-18 middle, 19 middle-20.)

3. That, in any event, the vast bulk of Phillips' rates, and by implication the rates of most other producers, are

[1] A fourth point (FPC Brief, pp. 20-23), directed solely to an argument raised by California, a petitioner in No. 756, is not considered in this memorandum.

subject to refund which could be ordered at the outcome of the area rate proceedings. (FPC Brief, pp. 18-19.)

None of these arguments warrants the Commission's request that certiorari be denied; all three are rather arguments suggesting affirmance of the decision below once certiorari is granted. We shall, nonetheless, direct ourselves to each of these arguments.

1. Contention That Allowance Of Rate Increases Was Proper

As part of its opinion in this case, the Commission allowed in full ten of the twelve Section 4 rate increases which had been consolidated with the Section 5 future-rate investigation. Pursuant to these increased rate filings, Phillips collected additional revenues of approximately $5.3 million annually in 1957-1959, and lesser amounts in 1955-1956. The stated basis for the Commission's action was the finding that in 1954 Phillips' jurisdictional costs were $54.5 million and its jurisdictional revenues $45.6 million. However, the Commission itself took the position that the 1954 test year was too stale to provide a basis for fixing future (i. e., 1960 and thereafter) rates in the Section 5 docket. By the same reasoning, of course, the 1954 test year would be too stale to evaluate the propriety of rate increases in effect between 1955 and 1959.

Furthermore, there is an even more compelling reason why the $8.9 million jurisdictional deficit in 1954 was an inadequate support for the allowance of the $5.3 million increase for the latter years. Throughout this entire period the Commission had authorized Phillips to initiate new sales at progressively higher and higher prices, a factor which could be expected to eliminate, or at least mitigate sharply, the $8.9 million deficit which obtained in 1954.

These new sales generated substantial additional revenues, which were given no consideration by the Commission when it allowed the instant rate increases to become final. See *Smith* v. *Illinois Bell Telephone Co.*, 282 U. S. 133 at 161-2 (1930).

2. Contention That SGP Levels Provide Adequate Protection

The Commission rather frankly recognizes (Brief, p. 15) that the refusal to regulate producer rates on an individual-company-cost basis pending the outcome of area rate hearings will result in a "hiatus in regulation" unless there is adequate interim control exercised during the long period necessary to bring the area rate proceedings to conclusion.

Before turning to the adequacy of the interim method chosen by the Commission, we wish to discuss the inordinate length of time which will be required to bring the area rate proceedings to that ultimate conclusion, and in this regard it is necessary to correct a perhaps inadvertent impression of progress created by the FPC's statement (p. 14) "that there are now in progress proceedings to fix [area rates] in two of the country's major producing areas, which are also two of Phillips' largest producing areas." We assume that the Commission here is referring to the area rate proceedings for the Permian Basin and for Southern Louisiana. As to the Permian Basin, which accounts for less than one-eighth of all gas sold in interstate commerce, hearings are indeed presently in progress, but they have thus far been confined to non-cost, non-financial-requirement types of evidence, notwithstanding the Commission's representation here (Brief, pp. 13-14) that the area prices will be based "on the reasonable financial requirements of the industry" and on "the use of typical

or composite cost data." Thus, the evidence which the Commission here asserts will be primarily relied on in fixing area rates has not yet even been presented by any party to the Permian Basin proceeding; the most that can be said of the proceeding is that, more than a year after its institution, it is still in a hopelessly early stage, with the key evidence not yet presented. The second proceeding, relating to area rates for Southern Louisiana, is even less advanced. Though instituted a year ago, it has proceeded no farther than inconclusive prehearing conferences, which are now in indefinite recess, and no formal hearing has been held, nor is any set. It is evident, therefore, that the estimate of the court below that another four to fourteen years would be required to bring the area rate proceedings to conclusion was, if anything, unduly optimistic.

We turn now to a consideration of the degree of consumer protection which will be afforded during the interim by the SGP levels, announced by administrative fiat contemporaneously with the Commission's Phillips Opinion. As we noted in our original petition, the policy statement sets forth for each producing area two levels—one, the "old gas" level, to be used as a guide to the Commission in determining whether to *suspend* Section 4 rate increases for old gas, and the other, the "new gas" level, to be used as a basis for imposing price conditions in certificating sales of new gas in interstate commerce. In our petition we alleged that the old gas level in each area was in essence the 1959 weighted average wellhead price for the area, and that the new gas level represented each area's highest previously certificated price at the time the policy statement was announced in September 1960 (see Petition, Appendix D). Though the Commission apparently disputes this analysis (FPC Brief, p. 17, n. 12), its denial is unsupported and hence unconvincing. It seems obvious, therefore, that

the "line" which the Commission proposes to hold by use of the SGP levels is the 1959-60 line—the product of *six years* of ineffectual regulation. In his recent and important report on the federal regulatory agencies, Dean Landis stated that the Commission's action in promulgating area rates,

> ". . . whether ultimately legal or not, has come far too late to protect the consumer. The area prices there set forth substantially reject the rate base approach and the fixed area prices come close to approximately current maximum prices, which have more than doubled in the past five years. The Commission's past inaction and past disregard of the consumer interest has led the states to seek to force it to discharge its responsibilities. It is somewhat of a phenomenon in our national life for the state utility commissions to be ranged against a federal commission in an effort to protect consumers against monopolistic and excessive rates."[2]

In an attempt to explain away a conflict between the decision below and the long line of decisions by the same and other circuits,[4] the Federal Power Commission draws a distinction, as novel as it is meaningless, between "current prices" and the lower "policy prices" that are to be used in determining whether to suspend rate increases

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[2] Landis, *Report on Regulatory Agencies to the President-Elect*, pp. 55-56 (1960).

[3] *City of Detroit* v. *F. P. C.*, 230 F. 2d 810 (1955), cert. denied, 352 U. S. 829; *Mississippi River Fuel Corp.* v. *F. P. C.*, 252 F. 2d 619 (1957), cert. denied, 355 U. S. 904; *Episcopal Theological Seminary* v. *F. P. C.*, 269 F. 2d 228 (1959), cert. denied, 361 U. S. 895; *Willmut Gas & Oil* v. *F. P. C.*, 299 F. 2d 111 (1962).

[4] *Bel Oil Co.* v. *F. P. C.*, 255 F. 2d 548 (5th Cir. 1958), cert. denied, 358 U. S. 804; *Forest Oil Co.* v. *F. P. C.*, 263 F. 2d 622 (5th Cir. 1959); *United Gas Improvement Co.* v. *F. P. C.*, 290 F. 2d 133 (5th Cir. 1961), cert. denied, 368 U. S. 823.

(Brief, pp. 19-20). Recognizing that use of "fair field prices" has been judicially discredited,[5] the Commission asserts that the "policy prices" are not "fair field prices" because they are "far below current prices". To the extent that the Commission is giving the phrase "current prices" its usual meaning—i.e., the weighted average price currently being paid for all gas in interstate commerce—the Commission's statement is incorrect. In 1959, the last year for which figures were available at the time the Commission adopted its area price levels, the weighted average price of gas sold in interstate commerce was 14.3¢ per Mcf, or almost exactly the level that would be arrived at using the Commission's "old gas" price levels, which range from a minimum of 11¢ to an apparent maximum, for the major producing states, of 15.75¢ per Mcf.[6] If, on the other hand, the Commission means by "current prices" not the prices being paid *on the average* for gas currently being *sold* in interstate commerce but the prices currently being negotiated or paid for *new* dedications of gas to the interstate market, its argument fares no better. At the time "fair field price" was first espoused by the Commission as a method of regulation[7] it represented not the "current price", in this esoteric sense, but rather the weighted average price for all gas being sold, which is *precisely* the same standard now used by the Commission in arriving at a "policy price" to determine whether to suspend rate increases.

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[5] See cases cited in previous two footnotes.

[6] The 15.75¢ price, adopted for Louisiana, includes, as does the 14.3¢ weighted average referred to earlier, an allowance for "tax reimbursement".

[7] *Panhandle Eastern Pipeline Company*, 13 FPC 53 (1954), rev'd sub nom. *City of Detroit* v. *F. P. C.*, 230 F. 2d 810 (D. C. Cir. 1955).

3. Contention That Bulk of Phillips' Rates Are Subject To Refund

As an integral part of the argument that its interim method of regulation—i.e., use of SGP levels pending outcome of the area proceedings—provides adequate consumer protection, the Federal Power Commission asserts (Brief, pp. 18-19) that over 80% of Phillips' 1960 jurisdictional revenues were collected subject to refund. The legal basis for this claim is nowhere stated—we suspect that it would be sharply challenged by Phillips, the Commission's co-respondent here—and we assume that it stems from the contention that when a natural gas company files a rate increase, the *entire* new rate, and not merely the amount of the *increase,* is subject to refund. To illustrate: assume a company files an increase under Section 4 from an existing level of 20¢ per Mcf to an increased level of 21¢ per Mcf, and the Federal Power Commission permits the increase to become effective subject to refund; after three years of collection at the higher rate, a hearing is held on the justness and reasonableness of the increased rate, and the Commission finds that the just and reasonable rate is 12¢; may it order refunds of the increased amount only (the 1¢) collected during the three years, or may it direct refunds of 9¢ for each Mcf sold during the entire three-year period?

We understand it to be the Commission's contention, asserted in its brief here, that it could order refunds of the entire amount, and it is on this basis that the 80% refund figure has been computed. The Commission is, of course, entitled to make such a contention. We are surprised, however, that it failed to advise this Court that the matter is an open one and that in 24 years of regulation under the Natural Gas Act the Commission apparently

has never directed refunds greater than the amount of the increase. In fact, the question was last presented to the Commission just a year ago, at which time the Commission stated: "It has apparently never been settled whether a refund can be ordered that reflects a rate decrease below settled rates previously in effect. We do not believe we have to decide that question here. . . ." *Panhandle Eastern Pipeline Company*, G-2506, FPC Opinion 344, 25 FPC 787 at 803 (1961).

Furthermore, in showing amounts collected subject to refund, both the industry (for income statement and balance sheet purposes) and the Commission have consistently shown only the amount of the *increase*, not the entire rate as increased. Thus, for example, the Annual Report (Form 301) filed with the FPC by Phillips for 1960—from which the Commission claims to have "computed" (Brief, p. 18, n. 15) that $74 million of Phillips 1960 revenues of $90 million are subject to refund—shows under the column "revenue subject to refund" a figure of only $20 million; and the report bears no notation that the figure is challenged by the FPC or its staff. Phillips' practice of showing as subject to refund only the amount of the increase is consistent with the practice followed by every other producer and pipeline in filing the Commission-required Annual Reports. Moreover, in its own statistical tabulations, in its reports to Congress, and in its prior representations to this Court, the Commission has always shown as subject to refund only the amount of the increase. F. P. C. Release 9602 (December 27, 1957); *Tabulation of Gas Rate Increases* (prepared by FPC at request of House Subcommittee on Legislative Oversight, April 15, 1960), pp. 8-9; Petition of FPC for Writ of Certiorari, pp. 27-28, esp. note 27, *F. P. C. v. Memphis Light, Gas and Water Division*, No. 694, October Term 1957.

But, even if the bulk of Phillips' rates were *assumed* to be subject to refund, this would be irrelevant, for as the Commission has itself recognized and as it has recently told this Court, consumers are not adequately protected while "they continue to pay excessive rates, by the [natural gas company's] ultimate obligation to refund the excess charges with interest". Petition of FPC for Writ of Certiorari, p. 10, *FPC* v. *Tennessee Gas Transmission Co.*, this term No. 591, cert. granted, 368 U. S. 974 (1962).[8]

And finally, upon the same assumption, is it not a sad commentary that 80% of the revenues of a major gas producer should be collected subject to refund and that such revenues should continue to be so tainted for another decade or so, while the Commission ignores the "just and reasonable" (to company and consumer) standard of the Natural Gas Act? Of what realism is the ostensible assurance of refund a decade or so hence, by even the strongest financial giant, of 80% of its total receipts for a past period of that magnitude?

• • • • • • •

The FPC asserts (Brief, pp. 10-11):[9]

> "No one can seriously deny that a regulatory agency has 'broad discretion in selecting an appropriate means or method of regulation.'"

As regulatory agencies themselves, petitioners agree with the point being made, but hasten to add that it is hardly dispositive of this case. Agency discretion must be exercised in a manner not inconsistent with the legislative purpose, *Atlantic Refining Co.* v. *Public Service Commission*,

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[8] Indeed, the whole basis for the interim order provision which the Commission so earnestly seeks to protect in the *Tennessee Gas* case is the Commission's recognition that refund provisions do not provide adequate protection to consumers.

[9] To similar effect, see Phillips Brief, pp. 18-19.

360 U. S. 378 (1959), and there is no theory of agency discretion which permits the Federal Power Commission to ignore for any period of time the mandate of Congress and of this Court to fix just and reasonable rates for Phillips Petroleum Company.[10]

For the reasons stated in the petition and in this memorandum we respectfully submit that the petition for a writ of certiorari should be granted.

Dated May 3, 1962.

Respectfully submitted,

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[10] In his *Report on Regulatory Agencies to the President-Elect* (1960), Dean Landis refers to "the unwillingness of the [Federal Power] Commission to assume its responsibilities under the Natural Gas Act and its attitude, substantially contemptuous, of refusing to obey the mandates of the Supreme Court of the United States. . . ." (p. 55)

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1962.

No. 72.

STATE OF WISCONSIN and PUBLIC SERVICE COMMISSION OF WISCONSIN, and

PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK,
Petitioners,

v.

FEDERAL POWER COMMISSION and PHILLIPS PETROLEUM COMPANY,
Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT.

BRIEF FOR STATE OF WISCONSIN and PUBLIC SERVICE COMMISSION OF WISCONSIN, and PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK.

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Opinions Below.

The opinion of the Court of Appeals (R. 410-430) is reported at 303 F. 2d 380. The opinion and order of the Federal Power Commission (R. 251-341) are reported at 24 F. P. C. 537, and the Commission's order denying rehearing (R. 395-404) is reported at 24 F. P. C. 1008. The decision of the presiding examiner (R. 35-217) is reported at 24 F. P. C. 590.

Jurisdiction.

The judgment of the Court of Appeals was entered on November 30, 1961 (R. 431-432). The petitions for a writ of certiorari were filed on February 28, 1962 and were granted on May 14, 1962 (R. 432-434; 369 U. S. 870). The jurisdiction of this Court rests on 28 U. S. C. §1254(1) and on Section 19(b) of the Natural Gas Act, 15 U. S. C. §717r(b).

Statutes Involved.

Sections 4 and 5(a) of the Natural Gas Act, 52 Stat. 822-823, 15 U. S. C. §§ 717c and 717d(a), provide as follows:

> SECTION 4. (a) All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.
>
> (b) No natural-gas company shall, with respect to any transportation or sale of natural gas subject to the jurisdiction of the Commission, (1) make or grant any undue preference or advantage to any person or subject any person to any undue prejudice or disadvantage, or (2) maintain any unreasonable difference in rates, charges, service, facilities, or in any other respect, either as between localities or as between classes of service.
>
> (c) Under such rules and regulations as the Commission may prescribe, every natural-gas company shall file with the Commission, within such time (not less than sixty days from the date this act takes effect)

and in such form as the Commission may designate, and shall keep open in convenient form and place for public inspection, schedules showing all rates and charges for any transportation or sale subject to the jurisdiction of the Commission, and the classifications, practices, and regulations affecting such rates and charges, together with all contracts which in any manner affect or relate to such rates, charges, classifications, and services.

(d) Unless the Commission otherwise orders, no change shall be made by any natural-gas company in any such rate, charge, classification, or service, or in any rule, regulation, or contract relating thereto, except after thirty days' notice to the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. The Commission, for good cause shown, may allow changes to take effect without requiring the thirty days' notice herein provided for by an order specifying the changes so to be made and the time when they shall take effect and the manner in which they shall be filed and published.

(e) Whenever any such new schedule is filed the Commission shall have authority, either upon complaint of any State, municipality, State commission or gas distributing company, or upon its own initiative without complaint, at once, and if it so orders, without answer or formal pleading by the natural-gas company, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the natural-gas company affected thereby a statement in writing of its reasons for such suspension,

may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect; and after full hearings, either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made at the expiration of the suspension period, on motion of the natural-gas company making the filing, the proposed change of rate, charge, classification, or service shall go into effect. Where increased rates or charges are thus made effective, the Commission may, by order, require the natural-gas company to furnish a bond, to be approved by the Commission, to refund any amounts ordered by the Commission, to keep accurate accounts in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts were paid, and, upon completion of the hearing and decision, to order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the natural-gas company, and the Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible.

SECTION 5. (a) Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with

any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: *Provided, however,* That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural-gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural-gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates.

Questions Presented.

1. Whether the Federal Power Commission may indefinitely defer the fixing of just and reasonable rates for sales by natural gas producers while embarking upon a novel, inchoate, and judicially untested method of producer rate regulation that cannot become effective for many years, when such indefinite deferral will cause substantial and irreparable injury to the consuming public.

2. Whether the Federal Power Commission may dismiss rate suspension proceedings and allow a natural gas company to retain rate increases collected between 1955 and 1959, on the basis of a finding that the company's 1954 costs (including a fair return) exceeded its 1954 revenues by 20%, when (a) the company's revenues were known to have increased by more than 50% between 1954 and 1959, and (b) the increased rates were discriminatory on their face.

Statement of Facts.

Under review here is the first (and only) major producer rate case to reach a decision on the merits following this Court's 1954 ruling that the Federal Power Commission has jurisdiction over interstate sales made by natural gas producers. *Phillips Petroleum Company* v. *Wisconsin*, 347 U. S. 672. The proceeding before the Commission involved both (1) an investigation, instituted by the Commission under Section 5 of the Act, into the justness and reasonableness of all of Phillips' interstate rates and (2) several applications by Phillips, under Section 4 of the Act, to increase certain of those rates. Although the case had been tried by all parties on the theory that Phillips' rates should be fixed by reference to its costs, the Commission ultimately held that individual-company cost was not a proper basis for fixing the rates of natural gas producers and terminated the Section 5 investigation. With respect to the Section 4 increases, the Commission found that since Phillips' 1954 jurisdictional costs (including return and taxes) exceeded the company's 1954 jurisdictional revenues by an amount greater than the total of the requested Section 4 increases, those increases—which had been collected by Phillips pending the outcome of the rate case—should be allowed in full. No finding was made that Phillips' costs exceeded its revenues in the post-1954 period during which the increased rates had actually been collected.

The original proceedings, 1948-1954—In October 1948 the Federal Power Commission instituted an investigation (F. P. C. Docket No. G-1148) under Section 5(a) of the Natural Gas Act to determine whether Phillips was a natural gas company and, if so, whether any of its rates were "unjust, unreasonable, unduly discriminatory, or

preferential" (R. 17-20), 7 F. P. C. 983. Following a full-scale field investigation and hearing, the Commission in August 1951 held that Phillips was not a natural gas company and terminated the proceeding, 10 F. P. C. 246. On review, the Court of Appeals for the District of Columbia Circuit reversed, and entered a judgment directing the Commission to "fix the rates at which [Phillips'] sales are made" (R. 405-406). *Wisconsin* v. *Federal Power Commission*, 205 F. 2d 706 at 712 (D. C. Cir. 1953). In June 1954, this Court affirmed the mandate of the Court of Appeals. *Phillips Petroleum Company* v. *Wisconsin*, 347 U. S. 672.

Federal Power Commission action on remand—Upon receiving the Court of Appeals' mandate, the Commission reinstated its Section 5(a) investigation into the lawfulness of Phillips' rates (R. 407-409); later it consolidated with the general investigation twelve specific rate increases which had been filed by Phillips under Section 4(e) between June 1954 and May 1956 (R. 21-23). Hearings in the consolidated proceeding commenced in June 1956. From the outset, the proceeding was recognized as *the* one which would establish a precedent for the Federal Power Commission's rate regulation of natural gas producers, for not only was Phillips the largest producer-seller of natural gas in interstate commerce and the subject of this Court's landmark 1954 opinion, but the Phillips investigation itself was the first of a series of investigations instituted by the Commission into the rates of almost all of the nation's larger producers and was the first to be set for hearing.[1]

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[1] To date, hearings have been concluded with respect to thirteen major producers, accounting for approximately one-third of all interstate sales of natural gas. In four of these proceedings examiners' decisions have been issued, and in five others all briefs have been filed. In each of these cases, as in the Phillips proceeding, complete cost presentations were introduced by the producer, by the staff of the Federal Power Commission, and by one or more interveners. See Appendix A.

Because of its trail-blazing quality, the trial of the Phillips proceeding was a lengthy one, extending over an 18-month period during which hearings were held on 82 days. The hearing record comprised 10,620 pages of transcript and 235 exhibits. At the commencement of the hearing all parties agreed that Phillips' rates should be determined on a cost-of-service basis (R. 60), and four major, full-scale cost-of-service studies were presented—one each by Phillips, by the FPC staff, by four Eastern Seaboard interveners (three of whom are petitioners in No. 74), and by the State and Public Service Commission of Wisconsin (a petitioner herein). Phillips cooperated in making available exhaustive data covering all phases of its natural gas business, including cost-of-service data for 1954, the test year accepted by all parties, and for 1956.[2]

The Examiner's decision—In April 1959, the Presiding Examiner issued an exceedingly comprehensive decision (reprinted, in part, R. 35-217; 24 F. P. C. 590), directed both to the general philosophy of producer rate regulation and to the specific application of that philosophy—on the basis of the instant hearing record—to Phillips Petroleum Company. Under the former heading, the Examiner analyzed the consistent lines of Commission and court opinions which had held that in fixing "just and reasonable" rates for natural gas producers "the conventional rate-base, or cost-of-service, method must be used at least as a point of departure" (R. 57, 59). He noted the persistent contentions made by many producers that the cost-of-service method was "unworkable" and "administratively unfeasible",

[2] The 1956 cost data were presented toward the conclusion of the hearings solely for the purpose of demonstrating that the 1954 data were in fact representative of the future (R. 86 n. 20).

but he accurately observed that these contentions had, up to the point of his decision, been made in a vacuum and not on the basis of any actual endeavor to apply a cost-of-service approach to a major gas producer (R. 58-63). In this connection he pointed out that at no time during the proceeding had Phillips taken the position that the cost-of-service method was unworkable or that it presented unduly complex problems (R. 62). Conceding that the record in the case had been a long one, he explained (R. 65) that

> "the length and complexity of the instant *Phillips* proceeding cannot fairly be regarded as representative of the situation which will be commonly encountered in future producer-rate proceedings, once the Commission has firmly established the applicable standards and methods to be used in determining producer rates. From that point on, the two categories of evidence outlined above [alternative proposals for the handling of various allocation problems, and presentation of general industry-wide data], which consumed so much time in the instant *Phillips* proceeding, will no longer be required."

The Examiner then turned to an examination of the evidence bearing on Phillips' jurisdictional cost of service[3] for the 1954 test year. He concluded that such cost was $57.3 million—equivalent to an average unit cost of 11.7¢ per Mcf (R. 211). He therefore directed Phillips to design and file a schedule of rates which, when applied to sales being made in 1954, would recover that cost of service (R. 214). He further directed that the rates for all sales instituted after 1954 should be adjusted to conform to the sched-

[3] As correctly noted by the court below, "Cost-of-service in this context includes not only operating expenses, taxes, exploration allowances, and gas purchases but also a fair return on the rate base." (R. 413 n. 5).

ule of rates thus derived (R. 215). Pursuant to this direction, Phillips prepared and filed a preliminary schedule of rates (R. 218-225).

The Commission's decision—Exceptions to the Examiner's decision having been filed and oral argument held, the Commission on September 28, 1960 issued its decision here under review. That decision, designated as Opinion No. 338, begins with a discussion (R. 256-269) of the feasibility of regulating independent natural gas producer rates through use of individual company costs and investment. Consistent with the Commission's previously expressed distaste for producer rate regulation,[4] the opinion recites the purported difficulties and unsolved problems which, according to the Commission, were the inevitable result of employing a cost-investment rate base as a starting (or any other) point in regulating natural gas producers. After noting the clogged condition of its dockets, the Commission concluded that it would be neither administratively nor economically sound to utilize individual producer costs to fix producer rates (R. 265).

While rejecting future reliance on individual producer costs, the opinion noted that cost-based regulation was "clearly a lawful way to determine rates for Phillips . . . and under the present record is the only possible method" (R. 269). Finding that the "jurisdictional cost of service for . . . [1956] was not very different from 1954" (R. 272), Respondent adopted the 1954 test year which had been employed by the Examiner and proceeded to find Phillips' jurisdictional cost of service to be $54.5 million[5] (subject

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[4] FPC, 35th Annual Report (1955), 177;
FPC, 37th Annual Report (1957), 17-18, 25;
FPC, 38th Annual Report (1958), 16-17;
FPC, 39th Annual Report (1959), 12-13, 18-19;
FPC, 40th Annual Report (1960), 17.

[5] As revised in the order denying rehearing (R. 401).

to adjustment for certain purchased gas costs, gathering taxes, and royalties) or 11.1¢ per Mcf on jurisdictional sales of 491,178,953 Mcf (R. 404). Jurisdictional revenues for 1954 were $45.6 million (R. 326), resulting in an apparent $8.9 million deficit for that year. (The 1954 revenues do not include, of course, additional revenues experienced in subsequent years (a) from the Section 4(e) increases consolidated with the rate investigation, (b) from *other* Section 4(e) increases, (c) from additional sales volume, and (d) from new sales at higher prices.)

After concluding that Phillips' rates were not excessive in 1954, the Commission inferred, without record support, that they were "probably" not excessive through 1958—by which date it recognized that "very substantial further rate increases were filed by Phillips" (R. 329). Since it also concluded that "there is nothing in the record to show that these past rates . . . are unduly discriminatory or preferential" (R. 326), the Commission terminated all but two of the Section 4(e) proceedings[6] and discharged Phillips from further refund obligation. It thereby approved existing[7] and increased rates made effective during the 1955-1959 period, solely on the basis of its consideration of 1954 costs and revenues.

With regard to the Section 5 investigation, involving Phillips' future rates, the Commission recognized that "the

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[6] The rates called for by the rate schedules involved in Docket Nos. G-10883 and G-11217 are subject to revision on contractual grounds, upon the decision of certain pending pipeline rate cases, and hence these dockets were held open on this limited issue (R. 326-329).

[7] Regularly since 1954, Respondent has authorized all producers, including Phillips, to undertake new sales at initial prices more than double the 1954 average price. Its justification for not scrutinizing the propriety of these prices at the time of initial certification was that it would eventually review them in the Section 5(a) investigations, wherein they could be prospectively lowered. See *Atlantic Refining Co.* v. *Public Service Commission of New York* (Cateo), 360 U. S. 378 (1959).

next step would ordinarily be to alter Phillips' rates . . . prospectively" (R. 323). Nevertheless, and despite the existence of almost a hundred rate increases filed by Phillips during the pendency of the proceeding[8] (R. 324, 329), Respondent terminated without further action the general Section 5(a) rate investigation. This action was justified on two principal grounds: (1) that it would be "a result without reason or justice" to fix Phillips' 1960 rates upon data for an earlier test year (R. 325); and (2) that "the interest of consumers and the exigencies of regulation will be better served in rate proceedings brought on an area basis rather than on an individual company basis" (R. 397).

Statement of General Policy No. 61-1—Concurrently with its opinion herein, Respondent issued a Statement of General Policy No. 61-1 (R. 343-348), 25 Fed. Reg. 9578, containing two lists of area prices—one for initial rates for new sales under Section 7 and another for increased rates (under Section 4(e)) for gas sold under existing contracts —for use "as a guide to us and to interested parties in determining whether proposed initial rates should be certificated without a price condition and whether proposed rate changes should be accepted or suspended" (R. 343). Respondent expressly represented, however, that the guides were tentative and did not purport to establish "just and reasonable" rate levels for Phillips or any other producer (R. 266, 346). The Policy Statement was issued without notice, hearing, or record, and has been amended several times since, also without notice, hearing, or record. (The levels set forth in Statement of General Policy 61-1 are hereafter referred to as "SGP levels" or "SGP rates.")

[8] As the opinion itself points out, the total annual impact of just five of these increases is approximately $11,000,000 (R. 324 n. 43).

Decision of the court below—On November 30, 1961, the Court of Appeals for the District of Columbia Circuit, Judge Fahy dissenting, sustained the Commission and affirmed its order.

The court analyzed the case by reference to three time periods. The first covered the "locked-in" period, running from February 1955 through July 1959, during which certain of Phillips' rates were subject to refund under the twelve Section 4(e) dockets. The second covered the period of Phillips' "current rates", that is, rates being charged in 1959 and to be charged thereafter until such time as the Commission's proposed area rate making procedures are formulated and placed into effect. The third time period follows completion of the proposed area rate proceedings, at which time rates for the future would be established by reference to the new area standard.

Considering the first time period, the majority held that the Commission had properly allowed Phillips' rate increases to become effective for the 1955-1959 period solely on the basis of its determination of 1954 costs and revenues.

After a brief discussion of the third period, involving Respondent's anticipated treatment of "future" rates in the proposed area proceedings,[9] the court then turned to the middle of the three time periods, that involving "current" rates. The court recognized that the "current" period could last as long as fourteen years and that Respondent is obligated to protect consumers during this period by some form of interim regulation. Although Respondent had proposed to defer regulation of existing rates indefinitely, the majority suggests that the Commis-

[9] Inasmuch as the Commission's plans for area proceedings are, as Judge Fahy noted, "now in an inchoate status" (R. 429), any consideration of the validity of such proceedings would be premature at this time.

sion will be able to use its SGP rates during this period to test the reasonableness of existing rates as well as to test proposed initial rates or to decide whether to suspend and investigate rate increases.[10]

Since the SGP rates, which had been adopted without notice, hearing, record, or specific findings, appear to be based primarily on then-existing field prices (See Appendix B and *infra*, pp. 29-33), the court, as a necessary support for its conclusions, held (1) that the Commission could lawfully base its determination of just and reasonable rates on field price data alone, without reference to the financial requirements of the producers (R. 424-425), and (2) that the SGP temporary rate levels were in fact "just and reasonable" rates which could be used for this purpose, subject only to challenge in individual rate proceedings (R. 424-425).

Finally, after pointing out (R. 426) that "the Commission has found . . . that present rates result in deficits to the Company",[11] the court concluded that the Commission's order was valid and should be affirmed.

Judge Fahy dissented[12] (R. 427-430). He pointed out that Respondent's opinion demonstrated the feasibility of

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[10] The court states (R. 426) that "the new method [i.e., the SGP interim rates] will also apply in 5(a) proceedings to any existing rate found to be unjust or unreasonable." As we shall show, *infra*, p. 33, the court here misconceives the purpose of the SGP interim levels, which were *not* intended by the Commission to be used in determining just and reasonable rates in Section 5(a) proceedings, but only in determining whether to suspend and investigate rate increases under Section 4, and in evaluating the surface propriety of initial rates in proceedings under Section 7.

[11] This is a misstatement, inasmuch as Respondent's finding was based on Phillips' 1954 costs as compared with its 1954 rates, and Respondent expressly refused to require Phillips to submit current cost and revenue figures relating to the "present" period of 1960-61 (R. 396-397).

[12] With partial concurrence on a point not raised by Petitioners herein.

deciding the Phillips' Sections 5(a) and 4(e) cases on the basis of the existing record, supplemented, if deemed necessary, by more recent data; that the majority should not have attempted to settle the validity of the area rate method since that question was not properly before it; that the result of the Commission's action would be to leave Phillips' rates unregulated for the indefinite future, which is entirely inconsistent with the mandate of the Natural Gas Act; that a Commission decision on the record, supplemented as necessary by more recent data, would be far more consistent with the mandate of the Act than the Commission's actual termination of the proceedings, based on the 1954 data; that the Commission could not dispose of the issue as to the justness and reasonableness of the present 1960-1961 rates on the basis of the 1954 data; that a decision in this case would not preclude the Commission from embarking on an area-rate-making program; and that the results of this and other Section 5(a) proceedings presently nearing completion before the Commission could provide assistance to the Commission in establishing guides of the SGP type, pending completion of the area proceedings.

Summary of Argument.

I

The purpose of the Natural Gas Act is, as this Court has frequently held, to underwrite just and reasonable rates to the consumers of natural gas. This statutory purpose is attained primarily through Federal Power Commission enforcement of the rate standards contained in Sections 4 and 5 of the Act: Section 4 declares unlawful any rate that is not just and reasonable, and Section 5

authorizes the Commission to fix just and reasonable rates for natural gas companies subject to its jurisdiction.

In 1954, this Court held that natural gas producers who sold their gas for resale in interstate commerce were, despite their status as producers, natural gas companies subject to Federal Power Commission jurisdiction. Pursuant to that decision, the Commission instituted investigations into the rates of most of the major producers.

In September 1960, after six years of ineffectual regulation which saw the average price of gas sold by producers increase more than 60%, the FPC had before it for decision the first major producer rate investigation, involving Phillips Petroleum Company. Although the proceeding had been tried by the parties and decided by the Examiner on the obvious and commonplace regulatory thesis that just and reasonable rates for Phillips should be fixed by reference to Phillips' costs, the Commission, expressing its belief that a more ideal way of fixing producer rates would be by reference to the financial needs of all producers in a given area, terminated the investigation without disturbing Phillips' existing rates and without passing on the justness and reasonableness of those rates. It took this action even though it knew that its preferred method—which was entirely novel, untried, and untested—could not be made fully effective, as the court below pointed out, for perhaps another fourteen years. It thus effectively suspended the Natural Gas Act's just and reasonable rate standard for an indeterminate period of time; this it had no power to do.

II

Admittedly, the Commission has a broad range of discretion in carrying out its statutory function of protecting

the consumer. But the breadth of that range does not permit it to defer indefinitely effective rate regulation of producers. Having proceeded through hearing and to point of decision in its investigation of the rates of Phillips Petroleum Company—the first of a series of investigations instituted by it into the rates of almost every major producer—the Commission was required to fix just and reasonable rates for Phillips by reference to the comprehensive evidence of Phillips' costs in the record before it, updated if need be. The Commission was not free to terminate this completed investigation—without making a finding on the justness and reasonableness of Phillips' rates—merely because it felt that a more ideal method of regulation would, if undertaken now, be ready for application five or ten years from now. The Commission's decision leaves Phillips free to collect rates which far exceed its costs and which are on their face unduly discriminatory and preferential. The area price "guides", which are to furnish the only semblance of control over producer rates until the area pricing method becomes fully effective many years hence, furnish inadequate consumer protection. In the first place, these guides freeze into permanence the 1959-60 price levels, which were the product of six years of ineffectual regulation. But even if the price guides were based on the rates in effect at the advent of producer regulation—the 1954 levels, which are substantially below those obtaining in 1959-60—they would represent nothing more than a codification of "fair field prices" (i.e., unregulated prices set by existing market forces), which cannot legally be used to fix just and reasonable rates.

Although practical difficulties prevented the FPC from instantaneously fixing just and reasonable rates for Phillips Petroleum Company and other producers upon being advised by this Court in mid-1954 that it had jurisdiction over producer rates, no concept of "deliberate speed" or of

reasonable time to comply with a judicial mandate permits the Commission to defer fixing just and reasonable rates for a period of up to 20 years from the date of mandate. The Commission's duty to hold prices stable *while* it determines just and reasonable rates cannot be substituted, as the Commission now proposes, for its duty *to fix* just and reasonable rates as promptly as possible. The Commission has mistaken its responsibilities; under the impression that its duty is discharged if it simply maintains price stability, it has ignored its primary responsibility to assure the consumer of the lowest reasonable rate.

The Commission further abused its discretion in this proceeding by allowing in full twelve rate increases requested by Phillips for the period 1955-1959 on the basis of a finding that 1954 costs exceeded 1954 revenues. The Commission's own records indicated that Phillips' revenues increased greatly in the post-1954 period, thereby suggesting that the revenue deficiency which may have existed in 1954 was either eliminated or sharply reduced during the 1955-59 period for which the increases were allowed. In addition, although the rates as increased ranged from 5.5¢ to 17.0¢ per Mcf, the Commission refused to make the obvious finding that they were discriminatory and preferential *per se*.

Argument.

Background of these Proceedings.

In 1954 this Court ruled that the Federal Power Commission had, and was required to exercise, regulatory jurisdiction over the rates for interstate sales made by gas producers. In response to that ruling, reached over its strenuous objection, the FPC took the following action:

1. It asked Congress to exempt producers from federal regulation, and when that request was denied, asked that regulatory control of producers be relaxed.[13]

2. It set up certain of the *forms* of regulation—i. e., it required all producers (a) to obtain certificates of public convenience and necessity to continue old sales or to commence new ones; (b) to file each of their gas sales contracts as a rate schedule; and (c) to file each contractual rate increase as a change in rate under Section 4 of the Natural Gas Act, which change, after the statutory five-month suspension period, then became effective, subject to refund at the conclusion of a hearing (seldom instituted) into the justness and reasonableness of the increased rate.

3. It instituted, after a number of false starts and side excursions, investigations on a company-by-company basis into the rates of most of the larger producers.

The Commission's activity under the first head—statutory release from its unwanted task of producer regulation—failed. The activity under the second head was essentially of a record-keeping nature and neither secured nor was intended to secure for the gas consumer his basic right under the Natural Gas Act—the right to pay no more than a just and reasonable rate. Not only did this regulation by record-keeping fail to disclose whether producer prices were just and reasonable at the advent of producer regulation—June 7, 1954—but it served to increase the June 1954 price markedly, both by permitting collection of increase after increase (subject to potential refund, to be sure) and by authorizing new sales at prices sharply higher than the average 1954 price. Thus, between 1954 and 1960 the average price of gas sold in interstate

[13] The Commission's legislative recommendations are cited at note 4, *supra*.

commerce rose from 9.9¢ to 15.6¢ per Mcf and the initial price level for new sales went up even more drastically. See *Atlantic Refining Co.* v. *Public Service Commission of New York*, 360 U. S. 378 (1959).

During this period, the FPC sought to minimize the seriousness of its own delays by pointing to its activity under the third head—the progress of the Section 5 investigations. And it was true that by the fall of 1960 the investigation of Phillips, the largest gas producer, accounting for 10% of the interstate market, was ready for Commission decision, and the investigations of twelve other major producers, accounting for an additional 25% of all sales, were in advanced stages of hearing. Moreover, the ultimate disposition of those proceedings promised to bring to the consumer a substantial measure of relief from the rapid escalation of producer prices, from 6.5¢ in 1950 to 9.9¢ in 1954 to 15.6¢ in 1960. Although the average costs for each producer varied, the data presented by the FPC staff revealed that the costs, including a fair return, ranged generally between 8.5¢ and 13.5¢—well below the 1960 average price of 15.6¢—and in the first case to be decided by an examiner, the instant Phillips case, the costs had been found to average 11.7¢.

It was at this juncture—with immediate and effective producer regulation within its grasp for the first time—that the Commission decided, in its Phillips Opinion and in the concurrently issued Statement of General Policy, that it would not regulate producers on an individual-company-cost basis but would instead pursue an area price method. It was not clear then, and after two years of experimentation with the new method it is not clear now, whether the FPC's new area price method was intended merely to change the *unit* of regulation—from the individual producing company to all producers in a given producing

area—or whether it was intended to change the *basis* of regulation—from fixing rates by reference to the cost of the regulated unit to fixing rates by reference to non-cost data. In its Brief in Opposition to the grant of certiorari, however, the FPC states (pp. 13-14) that the new method will be "based on the reasonable financial requirements of the industry," and will "involve the use of typical or composite cost data." In view of this representation, we shall assume that it is the intent of the FPC, under its new method, to regulate on a cost basis; as we shall show, however, this intent seems to be honored more in the breach than in the observance.

I.

Having proceeded through hearing to point of decision, the FPC was required to fix just and reasonable rates for Phillips by reference to Phillips' costs; it was not free to terminate the completed Section 5 investigation without making a finding on the justness and reasonableness of Phillips' rates merely because it felt that it would be preferable to fix rates for all producers by an alternative method—area pricing—which cannot be made effective for many years.

The FPC's action in terminating the Section 5 investigation without setting just and reasonable rates for Phillips was, we submit, irresponsible and illegal; not only did it throw into discard six years' effort at producer regulation, it did so without providing any reasonable alternative for the foreseeable future. Though not always phrased in the same way, the Commission's excuse for its refusal to fix rates for Phillips on the individual-company-cost record compiled in the Phillips hearing is its belief

that it would be desirable to utilize a different, and in its eyes better, method of regulation—the fixing of uniform rates for all producers in a given producing area by reference to the composite costs of those producers. The Commission and the court below frankly concede that the new method of regulation, which is untried, untested, and wholly inchoate at present, will require anywhere from four to fourteen years to complete. During this time rates will be tested by the area price guides announced by the Commission contemporanegusly with the issuance of its Phillips decision.

In the two years which have elapsed since that decision, the Commission has made abundantly clear that its holding in *Phillips* was general in scope. Since *Phillips* it has failed to decide a single producer rate case, although four such cases have been decided by FPC examiners on the basis of the individual-company costs presented in the hearings; and, while it has permitted (in some instances, directed) those producer rate investigations which were in hearing at the time of *Phillips* to proceed to conclusion and through briefing and examiner's decision, it has not set any new investigation for hearing, even though complete staff field investigations have been concluded as to at least five other major producers.[14]

The FPC has thus withdrawn its staff from the major producer rate investigations; it has substituted very little, however, in place of those investigations. In the two-year period since *Phillips*, it has instituted two area rate investigations—the Permian Basin (AR61-1) and the Southern Louisiana (AR61-2), two areas which account respectively for 12% and 20% of the gas sold in interstate

[14] FPC, *Management Information System*, p. 95 (as of March 31, 1962). The five producers account for 20% of all gas sold in interstate commerce.

commerce. The Permian Basin proceeding is presently in hearing before an FPC examiner—or in roughly the same procedural status as the Phillips proceeding was five years ago; the Southern Louisiana proceeding has not yet been set for hearing—i.e., it is not yet at the stage which the Phillips proceeding had reached more than six years ago.

No final decision can reasonably be expected in the Permian Basin proceeding before 1965 at the very earliest, and decisions in the other area proceedings are likely to be deferred until 1970 and beyond. As a result, the only price protection which the consumer will have during the '60's and into the '70's will come from the Commission's area price "guides", which thus form the basis not for some short-term, interim period of regulation but rather for producer regulation as it is presently administered and as it will be administered in the reasonably foreseeable future.

We turn now to an examination first of the effect of the Commission's decision on Phillips and second of the degree of consumer protection furnished by the area price guides.

A. The FPC's decision leaves Phillips free to collect rates which far exceed its costs.

The evidence of record is clear and for purposes of this appeal undisputed. In 1954, Phillips' jurisdictional costs (including a fair return on investment) were $54.5 million, or 11.1¢ per Mcf on jurisdictional sales of 491 million Mcf. Jurisdictional revenues for 1954 were $45.6 million, resulting in an $8.9 million deficit for that year. Had Phillips' revenues continued at their 1954 level in the succeeding years, there would be considerable justification for the Commission's termination of the Section 5 proceeding (except insofar as Phillips' rates were unduly discriminatory or preferential, a point discussed below). Phillips' revenues did not remain constant in the succeeding years, however,

and the Commission was well aware that they did not. As the figures below, taken from the annual reports filed by Phillips with the FPC, demonstrate, the rise was dramatic:

Phillips Petroleum Company
Jurisdictional Revenues, 1955-1961
(per Annual Reports filed with FPC)[15]

Year	Volumes	Revenues	Average Revenue
1955	512,659,668 Mcf	$45,765,076	8.9¢ per Mcf
1956	491,557,510	46,113,249	9.4
1957	544,753,619	53,725,619	9.9
1958	564,544,294	62,552,009	11.1
1959	602,232,993	74,463,308	12.3
1960	635,854,172	90,859,248	14.3
1961	608,756,938	91,628,487	15.0

The reason for the doubling of total revenues and the more than 50% increase in average unit revenue was well known to the Commission and was in fact the product of Commission action—i.e., over the years the Commission consistently authorized Phillips to undertake new sales at ever higher prices, and it permitted the collection by Phillips, subject in some but not all cases to possible refund, of increased rates for existing sales.

The Presiding Examiner recognized that the real problem in the Phillips situation—and the real injury to the consumer—lay not so much with Phillips' 1954 level of rates (again except insofar as its rates were unduly discriminatory or preferential, see below) but rather with the increased level of rates which had become effective between 1954 and the date of his decision (April 1959) and the increased rates which would thereafter become effective for both new and old sales. Because he found no evidence to

[15] The Commission required no annual report for 1954.

indicate that Phillips' average costs had increased in the period subsequent to 1954,[16] he directed Phillips to file uniform[17] rates (with adjustments made to reflect conditions of delivery) which would, if applied to sales being made in 1954, return Phillips' 1954 costs (R. 214). He further directed that this same schedule of rates be applied to all sales instituted between 1954 and the date of his decision, and to all sales instituted thereafter (R. 215). If Phillips' average costs per unit of sale increased in subsequent years and were not offset by increased revenues, the company would, under the Examiner's decision, be free to file a Section 4 rate increase to recoup such increase in costs (R. 193-196).

In rejecting the Examiner's result—and thereby leaving Phillips free to collect rates in some instances as high as 23.5¢ per Mcf, subject to no refund condition whatsoever—the Commission, as we have noted, relied principally on the thesis that since another method of regulation would be preferable (even though not immediately available), there would be no point in fixing Phillips' rates on the basis of the Company's costs. The Commission also advanced two subsidiary arguments for terminating the Section 5 investigation—first, it said that the test year (1954) was too stale to permit the fixing of rates for 1960 and thereafter; and second, it suggested that it had absolute power under Section 16 of the Natural Gas Act to terminate rate investigations. These subsidiary arguments may be disposed of briefly before turning our attention to what was obviously the Commission's real reason for termination.

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[16] Cost data from a later year (1956) indicated that Phillips' unit costs were remaining constant, see *infra*, p. 26, and note 2, *supra*.

[17] The Examiner concluded (R. 186-187) that uniform rates were necessary in order to eliminate the unreasonable preferences inherent in Phillips' existing rate structure. See *infra*, pp. 39-40.

As to the staleness of the test year, it may be useful to note why 1954 was chosen as the test year by all parties. The staff's investigation had been conducted in large part during 1955 and early 1956, at which time the latest full-year figures available were those for 1954. Hearings actually commenced in June 1956 and continued through December 1957. During the latter part of the hearings, in 1957, Phillips presented data for 1956, the latest full year for which figures were available prior to the conclusion of the hearing. Significantly, these figures were introduced not in an effort to impeach the use of 1954 as a test year but, on the contrary, to demonstrate that the cost experience for 1954 was virtually identical with that for 1956. Because of the length of the hearing and the novelty of the issues, the decisional process was long delayed; fifteen months elapsed between the conclusion of the hearing and the Examiner's decision, and another eighteen months elapsed between the Examiner's decision and the Commission's determination. Thus it was inevitable in this proceeding, and it will be inevitable in each of the Commission's area rate proceedings,[18] that the test year data will be anywhere from three to six years old by the time the Commission is ready for decision. If a three- to six-year-old test year justifies termination of a rate proceeding, then it will be impossible ever to fix rates for the future, and Section 5(a), insofar as it applies to regulation of producers, may as well be written out of the Act.

Petitioners, however, do not urge that the Commission was, in 1960, required to utilize the 1954 test year if it felt that test year was too stale to permit the fixing of future rates. What we do urge is that the remedy for staleness adopted by the Commission—termination of the proceed-

[18] At least until the first such proceeding has been decided on its merits.

ing—is a wholly inappropriate solution to the problem. If the Commission felt that 1954 data were too old, it could easily have reopened the proceeding to receive data of more recent vintage—say 1959. With the standards for determining cost already formulated in the cost-finding sections of the Commission's opinion, such a reopened hearing would have been concerned solely with the application of those standards to the later data. In other words, if, because of the staleness of the test year, the record was not all that the Commission desired, it had ample power to supplement that record and to proceed to decision on the basis of the record as supplemented.

As to the Commission's argument (R. 395-396) that it had, under the catch-all provisions of Section 16, absolute power to terminate any proceeding at any time, the point was apparently a make-weight, and was not urged by Commission counsel in the court below.[19]

We turn now to a discussion of the principal reason for the Commission's termination—its belief that the area price method would, upon ultimate formulation and application, provide a more ideal basis for producer rate regulation than the company-by-company cost approach.

Before proceeding with this discussion, however, we note that this is *not* a case in which an agency held a hearing in an admittedly trail-blazing proceeding to test the comparative value of two competing methods of regulation, chose one over the other, and fixed rates on the basis of the preferred method. Rather, and the difference is crucial, this is a case in which the Commission held hearings upon only a single method of regulation—the indi-

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[19] In March 1961, six months after the FPC's Phillips opinion, the D. C. Circuit reversed an earlier FPC attempt to "terminate" a rate case and thereby allow the increase to remain in effect without reaching a decision on the merits. *Minneapolis Gas Company* v. *F. P. C.*, 294 F. 2d 212 (D. C. Cir. 1961).

vidual-company-cost method which had been consistently applied by it in its regulation of pipelines and which was the usual, if not the exclusive, method of regulation used by other regulatory agencies, both federal and state, under cognate statutes—and then, at the conclusion of the proceeding, *sua sponte*, concluded that an alternative method, which might be ready five or ten years in the future, would be preferable; it therefore declined to fix rates on the basis of the method presented to it. But there was no logical basis for the Commission's action; there was no reason why the Commission could not have proceeded on an individual-company-cost basis until such time as its preferred area-wide method should become effective. Indeed, as Judge Fahy, dissenting below, correctly noted (R. 430):

> "The decision of these cases under the standards of the Act not only would not preclude the Commission from embarking upon the area method, but it also would not preclude the Commission from correcting or modifying the decision should the area proceeding show such correction or modification to be desirable; nor do I think a decision on the present record, supplemented as may be needed, would preclude the Commission, pending conclusion of an area proceeding, from establishing guides, formulated, however, with the aid of a decision in the present proceedings."

Inasmuch as area pricing will not be available until some time in the distant future, there is no occasion here to consider the merits of that method. For present purposes it should be observed, however, that, unlike the older, individual-company-cost approach, area pricing on an industry-wide cost basis is not free from challenge as to its legality. A number of producers have already served notice that if their costs exceed the Commission-determined

industry average, they will insist upon rates geared to *their* costs, and will claim that application to them of rates fixed by reference to the industry standard would constitute confiscation. If these producers are right—something which admittedly can be settled only after the Commission applies its area pricing method and after an appeal is taken—then area pricing will permit a producer to choose between the rate fixed by reference to the industry's average cost and that fixed by reference to its own cost, whichever is higher. Thus the consumer will be deprived of the low rate from the low-cost producer, who will receive a windfall under the new system, while being required to pay the above-average cost of the high-cost producer.

It is primarily the present, however, which concerns us here. For the present and for the foreseeable future the Commission's regulation of producer prices will operate only through use of the price guides established by Statement of General Policy 61-1 (the SGP rates). It becomes appropriate, therefore, to examine more closely into the nature of these guides. Preliminarily, it should be pointed out that the SGP rates sprang, Minerva-like, directly from the Commission's brow, without benefit of those birth-delaying processes—notice, hearing, and record. In consequence, and because they were purportedly to be used only as "guides," the SGP levels *per se* were held nonreviewable. *Wisconsin* v. *Federal Power Commission*, 292 F. 2d 753 (D. C. Cir. 1961).

In deriving the SGP rates, the Commission, as a first step, divided this nation's major producing areas into twenty-three geographic regions on the basis of common pricing patterns.[29] Then for each pricing area the Commis-

[29] Thus, the State of Louisiana was divided into two pricing areas—Northern Louisiana and Southern Louisiana—to reflect the fact that historically prices in one area have tended to move independently of prices in the other.

sion fixed two levels—the initial-service-rate level (sometimes called the new-gas price) and the increased-rate level (the old-gas price). The former, the Commission said, would be used as a guide to evaluate proposed initial sales; where a rate higher than the initial-service rate for the area was proposed, the sale would "be denied a certificate or certificated only upon the condition that lower rates be filed" (R. 346). In the case of a rate increase under Section 4, the Commission stated that it would suspend only where the rate exceeded the increased-rate level.

Notwithstanding the importance of these levels, the Commission was exceedingly vague in stating how they had been derived (R. 345):

> "In arriving at the price levels for the various areas set forth in the appendix to this statement, we have considered all of the relevant facts available to us. Such consideration included cost information from all decided and pending cases, existing and historical price structures, volumes of production, trends in production, price trends in the various areas over a number of years, trends in exploration and development, trends in demands, and the available markets for the gas."

Neither the Commission's original statement nor any of its pronouncements since have indicated how all of these various factors were weighed or evaluated one as against the other. Did the Commission start, for example, with cost information and adjust upward to reflect trends in production and downward to reflect increased volumes of production? How does one weigh "trends in demand" as against "existing and historical price structures"? And by what algebraic magic may "the available market for the gas" and "trends in exploration and development" be worked into an equation which will produce, with decimal precision,

twenty-three pricing areas and forty-six price levels? The short answer is that the Commission neither explained what it did nor how it could have done what it said it did. The longer, and in all probability the more accurate, answer is that there was one factor and only one factor which dictated the formulation of the area price levels—existing price structures. For the new-gas level, the Commission picked, in essence, the highest permanently certificated rate in the area as of September 1960. See Appendix B.[21] The old-gas levels announced for each area were essentially the average weighted price for all gas sold from the area in interstate commerce in 1959, with the figures rounded off to make a more consistent pattern. Thus the Commission was saying in *Phillips* and in the Policy Statement that it would authorize new sales in the post-1960 period so long as the sale was no higher than the highest price certificated prior to September 1960, and it would permit, without suspension or investigation, Section 4 increases where the increased rate was no higher than the average of all gas sold in the area as of that time.

With his characteristic perception, Dean Landis has pin-pointed both the substantive and the legal defects inherent in this method of area pricing:

> "The recent action of the Commission on September 28, 1960 in promulgating area rates, whether ultimately legal or not, has come far too late to protect the consumer. The area prices there set forth substantially reject the rate base approach and the

[21] Appendix B is identical with Appendix D attached to our Petition for Certiorari. In its Brief in Opposition (p. 17, n. 12) the FPC stated that it "dispute[s] the factual premises" of our argument that the initial-service rate was derived from the highest permanently certificated rate as of September 1960. But this naked assertion was clothed neither with supporting argument nor with a countering factual basis; significantly, the FPC did not dispute the coincidence of initial-service rates with highest previously certificated rates.

> fixed area prices come close to approximately current maximum prices, which have more than doubled in the past five years." Landis, *Report on Regulatory Agencies to the President-Elect*, p. 55 (1960).

As Dean Landis suggests, it would be bad enough had the Commission in setting up area prices merely substituted a field-price standard for the cost or rate base approach. What makes the substitution all the more egregious is that the Commission accepted the 1959-60 field-price levels, even though these levels had increased sharply since 1954 *because of* the Commission's failure to exercise even a minimum of effective producer rate regulation during this crucial period.[22]

Of course, it is accepted law, which we do not understand the Commission to challenge directly, that rate regulation under the Natural Gas Act must be predicated on cost. *City of Detroit* v. *F. P. C.*, 230 F. 2d 810 (D. C. Cir. 1955), *cert. denied*, 352 U. S. 829; *Mississippi River Fuel Corp.* v. *F. P. C.*, 252 F. 2d 619 (D. C. Cir. 1957), *cert. denied*, 355 U. S. 904; *Bel Oil Corp.* v. *F. P. C.*, 255 F. 2d 548 (5th Cir. 1958), *cert. denied*, 358 U. S. 804; *Forest Oil Corp.* v. *F. P. C.*, 263 F. 2d 622 (5th Cir. 1959); *Episcopal Theological Seminary* v. *F. P. C.*, 269 F. 2d 228 (D. C. Cir. 1959), *cert. denied*, 361 U. S. 895; *United Gas Improvement* v. *F. P. C.*, 290 F. 2d 133 (5th Cir. 1961), *cert. denied*, 368 U. S. 823. And we understand the Commission's reasoning in *Phillips* and the Policy Statement, as explained by its Brief in Opposition to the grant of certiorari in this case, to mean no more than that it is shifting from individual-company cost now to industry-wide cost prospectively. Yet under the guise of shifting from one type of cost to another, the Com-

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[22] See Smith, "The Unnatural Problems of Natural Gas," Fortune Magazine, Sept. 1959, p. 120.

mission has, for the present and foreseeable future, abandoned all meaningful regulation and substituted in its place a variant of the notorious and totally discredited fair-field-price method. Indeed, the field-price system established by the area price guides is far more vicious than earlier field-price systems that have been disapproved by the courts. Thus, in *City of Detroit* v. *F. P. C.*, 230 F. 2d 810 (D. C. Cir. 1955), *cert. denied*, 352 U. S. 829, the field-price standard there urged and rejected as not constituting a valid regulatory method was directly comparable to the old-gas price (without, of course, the inflationary effect of six years of do-nothing Commission regulation). Under the Commission's present system, however, producers would not only have the benefit of the old-gas level to govern the price of gas explored for, discovered, and dedicated to the interstate market five and ten and twenty years ago, but would be entitled to a new-gas price up to 50% in excess of the old-gas level for additional dedications to the interstate market.

It is true that the Commission has stated that the SGP levels are intended merely as guides to Commission action in issuing certificates and in determining whether to suspend proposed rate increases; indeed, the Commission itself has stressed that the price guides are not intended to fix just and reasonable rates.[23] But despite these protesta-

[23] In the original Statement of General Policy, the Commission expressly stated (R. 346) that the SGP levels would not "fix the ultimate justness and reasonableness of any rate level," and this sentiment has frequently been repeated since. Thus, for example, in a formal opinion issued six weeks after the decision of the court below, the Commission stated:

> "The area price levels, as set forth in the Policy Statement and its amendments, are 'for the purpose of guidance and initial action by the Commission,' and do not constitute determinations of just and reasonable prices." *Panhandle Eastern Pipe Line Co.*, Op. No. 350 (January 15, 1962) Mimeo., p. 9.

tions, the Commission has in fact utilized the price guides for the comparable purpose of settling producer rate investigations which have proceeded through the hearing and initial decision process on a cost basis. Thus, for example, in the Tidewater Oil Company rate investigation, G-13310 et al, decided September 14, 1961 by the same examiner who decided the instant Phillips investigation, the Commission, rather than decide the case, extended the time for filing exceptions from the twenty days required by its rules to nine months and sixteen days in order that a settlement might be negotiated. The basis for settlement ultimately accepted by the parties was in no way related to the cost as determined by the examiner or as urged by any party to the proceeding; rather it corresponded to the fair-field-price level enshrined in the Commission's Policy Statement. Faced, however, with a Commission refusal to decide the case on its merits—and so long as the case remained unsettled Tidewater continued to collect increasingly higher rates, some but not all of which were subject to refund—the interveners finally agreed to a settlement. Commission approval followed on June 15, 1962.[24]

A comparison of the results of the settlement, based on a fair-field-price theory, with the indicated results of the examiner's decision, predicated on cost plus fair return, is instructive. Under the examiner's decision, Tidewater's costs were 11.5¢ per Mcf and its average revenue would, of course, be the same; under the settlement, Tidewater's average revenues will be 15.9¢ per Mcf (at the time of settlement, Tidewater's rates averaged approximately 17.5¢ per Mcf). Under the examiner's decision, all of Tidewater's requests for rate increases would have been disallowed; under the settlement, Tide-

[24] *Tidewater Oil Co.*, G-13310 et al., Order Conditionally Approving General Rate Settlement Proposal (June 15, 1962).

water will be permitted to retain approximately $2.2 million of the $3.3 million annual increase it had sought. Under the examiner's decision, Tidewater would have been required to refund approximately $10 million in unjustified rate increases collected subject to refund; under the settlement, Tidewater will be required to refund only $4 million.

The Tidewater settlement set the pattern of the day—i.e., examiners determine cost of service; the Commission does not decide; in order to end the matter and attain some stability in gas costs (and relief from high Section 4(e) rates) interveners join in or condone settlements based on the interim area price levels,[25] which are nothing more nor less than fair field prices.

But, as noted above, the courts have repeatedly and consistently held that fair-field-price regulation is not meaningful regulation and certainly not the type of regulation contemplated by the Natural Gas Act. We do not believe the point requires extended discussion here; suffice it to say that fair-field-price regulation is not regulation at all, it is merely ratification of the market price.[26]

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[25] See *Ohio Oil Co.*, RI60-92 et al., Order Approving General Rate Settlement Proposal (June 28, 1962), where the Commission stated:

> ". . . the Commission approves of and wants to encourage settlements which dispose of most of a producer's pending rate problems, *which do so in accord with our area rate ceilings*, which provide for a reasonable moratorium on increased rate filings, which require refunds where appropriate, which lend certainty to the purchased gas costs of buyers, and which free the producer's revenues from contingencies that inhibit exploratory and developmental activities." Mimeo., pp. 3-4. (Emphasis added; footnote omitted.)

To the same effect, see *Shell Oil Co.*, G-9446 et al., Order Conditionally Approving General Rate Settlement Proposal (Aug. 1, 1962).

[26] This thought was succinctly expressed by the Fifth Circuit just a year ago:

> "As we have previously stated in Bel Oil Corp. v. F. P. C., 5 Cir., 255 F. 2d 548, 553, a price paid for gas as the

In addition, we do not understand the Commission, despite its present enthusiasm for such fair-field-price producer rate settlements, to contend that fair field price is a valid method of regulation. The most we understand the Commission to say is that industry-wide cost should be substituted for individual-company cost. Our complaint here is precisely the lack of any logical connection between the Commission's claim that industry-wide cost is the best method and its actual use for the present and foreseeable future of the fair-field-price method of regulation. Indeed, since the Commission appears to recognize that a cost method is required by the Gas Act, is workable under the Gas Act, and is desirable under the Gas Act, we are at a loss to understand why the Commission refuses to utilize the only cost method presently available—individual-company cost—while its ideal method is being worked out.

B. The FPC's decision deprives the consumer of his right to pay no more than a just and reasonable rate.

Upon being told by this Court in 1954 that producers selling natural gas for resale in interstate commerce were subject to regulation under the Natural Gas Act, the Com-

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result of arm's length bargaining with the producer is not, merely because bargained for in a highly competitive market, 'just and reasonable' within the intendment of the Natural Gas Act, 15 U. S. C. A. §717 *et seq.* See also New York Public Service Comm. v. F. P. C., D. C. Cir., 287 F. 2d 143. This is so because the only justification for giving the Commission the duty to regulate prices was the determination by Congress that the producers have a supply that is so restricted in relation to demand that they have the economic power to bargain for prices that will be injurious to the public. 'The purpose of the Natural Gas Act was to underwrite just and reasonable rates to the consumers of natural gas.' Atlantic Refining Co. v. P. S. C., 360 U. S. 378, 388." *United Gas Improvement* v. *F. P. C.*, 290 F. 2d 133 at 135 (5th Cir. 1961).

mission's responsibilities fell into two major categories: First, it was obliged to fix, as rapidly as possible, the just and reasonable rate for producer sales—a task then 16 years overdue. Second, since it was evident that the ultimate fixing of producer rates would take some time, the Commission was under an obligation to maintain control over price levels until it could, by completing its first task, determine whether adjustments were necessary. Unfortunately, during the period 1954-60, respondent neither stabilized the price level pending ultimate conclusion of the rate proceedings—in this period the average price of gas sold by producers to interstate pipelines advanced from 9.9¢ to 15.6¢ per Mcf[27]—nor did it move with any element of speed in its rate-fixing proceedings. The Commission now proposes, in *Phillips* and in its Policy Statement, to drag out for another five or ten years the finding of just and reasonable rates; any stability in prices accomplished in the interim will be at or near the 1959-60 levels.[28]

It is thus obvious that the Commission has completely mistaken its function as a regulatory agency. The Commission is *not* intended, in the manner of a wage stabilization board or an office of price administration, merely to stabilize

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[27] The 1954 level of 9.9¢ represented an all-time high, and compares with a range of 4.5¢-6.5¢ between 1938 and 1950.

[28] It should be noted that the Commission's decision to stabilize came only after its more egregious failures to do so were reversed twice by this Court and six times by courts of appeals. *Atlantic Refining Co. v. Public Service Commission of New York*, 360 U. S. 378 (1959); *Public Service Commission of New York v. F. P. C.*, 361 U. S. 195 (1959); *United Gas Improvement v. F. P. C.*, 283 F. 2d 817 (9th Cir. 1960), *cert. denied*, 365 U. S. 879, 881; *Public Service Commission of New York v. F. P. C.*, 287 F. 2d 146 (D. C. Cir. 1960), *cert. denied*, 365 U. S. 880, 882; *Public Service Commission of New York v. F. P. C.*, 287 F. 2d 143 (D. C. Cir. 1960); *United Gas Improvement v. F. P. C.*, 287 F. 2d 159 (10th Cir. 1961); *United Gas Improvement v. F. P. C.*, 290 F. 2d 133 (5th Cir. 1961), *cert. denied*, 368 U. S. 823; *United Gas Improvement v. F. P. C.*, 290 F. 2d 147 (5th Cir. 1961), *cert denied*, 366 U. S. 965.

prices or to prevent further price rises. Rather the Natural Gas Act imposes upon the Commission the affirmative duty of fixing just and reasonable rates for all gas sold in interstate commerce. While concededly the Commission must be permitted an appropriate length of time within which to carry out this affirmative function, a period of 10 to 20 years from the date of this Court's 1954 decision is patently unreasonable by any standards. It is made even more unreasonable by the present availability of tools—the individual-company rate
used to fix just and reasonable r...
after all, a practical ventu...e, not an ac...
determine the most ideal methodology regardless ...
sequences.

C. The FPC's decision leaves Phillips free to charge rates which are on their face unduly discriminatory and preferential.

In our argument thus far we have directed ourselves to the contention that the Commission's decision of September 28, 1960 is erroneous because it leaves Phillips free to collect rates which are unjust and unreasonable in that they generate, both on an over-all and on an average unit basis, a level of revenues in excess of those required by Phillips' costs as demonstrated on the record before the Commission. We turn in this section to our second contention, that the Commission's order terminating the proceedings would be erroneous, even if Phillips' rates produced no greater revenues than its costs, in that the decision leaves standing a patchwork of inconsistent rates, ranging from a low of 1¢ per Mcf to a high of 23.5¢ per Mcf, which are on their face unduly discriminatory and preferential, in violation of Sections 4(a), 4(b), and 5(a) of the Natural Gas Act.

Section 4(a) declares unlawful any rate "that is not just and reasonable". Section 4(b) provides that no natural

gas company shall "(1) make or grant any undue preference or advantage to any person or subject any person to any undue prejudice or disadvantage, or (2) maintain any unreasonable difference in rates . . . either as between localities or as between classes of service." Section 5(a) provides that whenever the Commission "shall find that any rate" charged by a natural gas company "is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate

term contracts usually of 20-year duration to interstate pipelines on the basis of the best bargain it could get. The price varied from contract to contract depending on such factors as the need of the pipeline for the particular gas, the need of Phillips to dispose of the gas promptly, the level of the other prices being negotiated by buyers and sellers in adjacent fields, and similar factors which determine price in a freely competitive market but which are entitled to little if any consideration in the regulatory sphere.

The question of proper rate design was discussed at length by the Presiding Examiner in his decision (R. 160-196). He noted (R. 178) that Phillips' rate structure on June 7, 1954—the date of this Court's Phillips decision and the date used by the FPC to mark the advent of producer rate regulation—included prices which ranged from a low of 1.2¢ to a high of 15.7¢ per Mcf, and he held that any attempt to continue such a structure would preserve for Phillips "an unduly discriminatory rate structure which would be contrary to the public interest". He also

noted with approval the contention made by the Commission staff that "Phillips' contract rates vary so widely, even as between contracts for the same service from the same producing areas, as to patently contravene the public interest, generating and perpetuating undue preference and undue discrimination" (R. 178-179). He therefore concluded that a uniform rate should be adopted, with adjustments only for differing conditions of delivery (i. e., fixed differentials for point of delivery, pressure, dehydration, and impurities). In support of his conclusion, the Examiner specifically found (R. 187):

> "[It (the uniform rate) would eliminate unreasonable preferences currently enjoyed by pipelines which are still purchasing gas under old, abnormally low-priced contracts—preferences which are based not merely upon differences in cost levels, but which reflect other historic reasons."

Although agreeing with the Examiner that Phillips' average unit cost was in the 11-12¢ range, the Commission, in a brief conclusory discussion, cavalierly brushed aside the Examiner's finding of undue discrimination and preference. Speaking of the Section 5(a) proceeding, the Commission stated "there is nothing to show that Phillips' contracts relating to Phillips' diverse conditions of sale are unduly discriminatory or preferential" (R. 325). Though conceding that there was "considerable diversity among the rates," the Commission in discussing the Section 4(e) aspect of the case again repeated its conclusory statement that "there is nothing in the record to show that these past rates reflecting the different conditions of sale are unduly discriminatory or preferential" (R. 326). On rehearing, Wisconsin pointed out that a number of Section 4 increases were to levels well in excess of the average unit cost of ser-

vice; in denying rehearing the Commission stated, "The fact that some of these rates are in excess of the average cost of service determined by us is immaterial", and again repeated its statement that there was "nothing to show that these rates are discriminatory or preferential" (R. 397).

Surely, it is difficult to imagine a situation more unduly discriminatory and preferential than a rate structure which varies from 1.2¢ to 15.7¢ per Mcf[29] without even a claim that the differences in price are related to differences in cost. It is also difficult to imagine how, under the Commission's approach, a finding of undue discrimination and preference could ever be made.

A recent examiner's decision lays bare the discriminatory, and hence illegal, nature of price differentials of precisely the type involved here:

> "It is fundamental that all customers of the same class within an area, who receive from a producer the same kind of service under the same or similar conditions, must pay the same rate. The uniform rate thus automatically becomes the proper rate. As the Commission had occasion to state in affirming the Examiner in *Willmut Gas & Oil Co., et al.* v. *United Gas Pipe Line Co.*, Docket No. G-1158, 12 FPC 132, 145:
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> > 'An unreasonable difference in rates under substantially similar conditions of service constitutes unjust discrimination. *Western Union Telegraph Co.* v. *Call Publishing Co.*, 181 U. S. 92. United concedes that, under this definition, unjust discrimination exists if Willmut is required to pay a higher price for gas under like conditions of service. The premise upon which the right to the same price stands is, as the Supreme Court said, "like conditions of ser-

[29] By 1960, certain of Phillips' rates were as high as 23.5¢ per Mcf.

vice." These conditions have been shown. And since "all individuals have equal rights both in respect to service and charges", which was also said in the *Western Union* case, the logical consequence is that Willmut is entitled to the same rate as MVG, as the examiner properly found. For United to charge one customer approximately 50 percent more for gas delivered under substantially similar conditions is to require such customer to pay an unreasonable and unduly discriminatory rate.'

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"The charging of different rates for the same class of service rendered under the same or similar conditions clearly enables producers to circumvent the statutory scheme of regulation with the result that 'the basic purpose of the * * * Act fails of realization' (*Michigan Consolidated Gas Co.* v. *Panhandle Eastern Pipe Line Co.*, 173 F. 2d 784, 789).

"In the Examiner's view, if the Commission is to carry out the intent of the Act to protect consumers and keep its difficulties relating to producer rate regulation from snowballing, it must in every rate case such as this do what it has directed be done here, namely, fix uniform rates for the future. This makes the Commission the master of the tools it has fashioned rather than being mastered by them. There can be no question but that if the Commission had failed to fix uniform rates for pipelines for the future in the same manner that it failed to fix *Phillips'* rates for the future, the Commission would today be in somewhat the same position with respect to pipeline rates that it finds itself in with respect to producer rates. The failure in a producer rate case to fix uniform rates for the future, and thereafter cause subsequently filed rates to conform to the uniform area rate, is an open invitation to producers to continue to attempt to exact still higher, unjust, unreasonable, discriminatory and preferential rates, and places the burden on the Commission, which

is endeavoring to shorten its hearing processes, to expand certificate hearings to receive evidence as to the condition that should be included with reference to the level of the rates involved therein." *Amerada Petroleum Co.*, G-9385 et al, Examiner's Decision (April 9, 1962) Mimeo., pp. 70-72.

II.

The FPC abused its discretion in allowing the Section 4 increases for the period 1955-1959 on the basis of a finding that 1954 costs exceeded 1954 revenues.

In view of the undisputed facts of record in this proceeding, the Commission's termination of the Section 4 dockets is wholly unjustifiable. Before describing the nature and history of these dockets, however, we note that the Commission's termination of the Section 4(e) suspension dockets is the equivalent of allowing the increases in full.

When a proposed rate increase is filed with the Commission under Section 4(d), the Commission has power under Section 4(e) to institute a hearing into the propriety of the increase and to suspend its operation for a period of five months. Assuming what is usually the case, that the Commission does not conclude its hearing within the five-month period, the increase becomes effective, subject to refund of any portion later found unjustified.[30] If the Commission thereafter terminates the Section 4(e) proceeding and, as

[30] It frequently happens, and indeed it was the situation here, that before the Commission can conclude its hearing on the propriety of an increase, a second and even a third and a fourth increase for the same sale has been filed, suspended, and collected subject to refund. The span of effectiveness of an increase thus superseded is customarily referred to as the "locked-in" period.

part of the termination, discharges the natural gas company from its obligation to refund excessive amounts, it thereby approves in full the requested rate increase.

In the instant proceeding, the twelve Section 4 increases allowed by the Commission were filed by Phillips between June 1954 and May 1956; the filings were not predicated on any increase in costs to Phillips but simply reflected increases to which Phillips was entitled under its contracts with various of its purchasers. The increased rates ranged from 5.5¢ (G-3175) to 17.0¢ per Mcf (G-4333). Each increase was suspended by the Commission; each became effective at the end of the five-month suspension period; and each remained in effect until it was in turn superseded by a later filing. The twelve increases became effective on various dates in 1955 and 1956, and were superseded in 1959 and 1960. At the time the increases were filed, Phillips estimated that they would generate additional revenues of approximately $5.3 million annually.

The Commission and the Presiding Examiner were in basic agreement that in 1954 Phillips' revenues were approximately $46 million, or roughly 9¢ per Mcf on the average, and that its costs were $55 million, or roughly 11¢ per Mcf. Because of the way in which the Examiner disposed of the case, the particular level of Phillips' 1954 revenues made little difference; the Examiner provided that Phillips' rates for the period 1954 to the present and continuing into the future should be fixed on a uniform basis by reference to Phillips' 1954 average cost of 11¢.

The Commission, however, held that because Phillips had a revenue deficiency of $9 million in 1954, a $5.3 million increase in its 1954 revenues would not have resulted in excessive revenues; from this correct holding, it proceeded to the erroneous conclusion that the Section 4 proceedings

should be terminated. This conclusion is erroneous because it permits Phillips to retain the $5.3 million increase for each year during the period 1955-1959. If we could assume that Phillips' revenues remained constant during the 1954-1959 period, then the Commission's treatment insofar as it related to level of revenue would be eminently correct. But in point of fact, Phillips' revenues did not remain constant; as the result of additional sales volumes, increased rates for old sales, and new sales at higher prices, revenues virtually doubled. See p. 24, *supra.*

If the Commission wished to decide the Section 4(e) dockets on a revenue deficiency basis, it was incumbent on it to determine whether there was *in fact* a deficiency each year during the period in which the increases were collected, see *Smith* v. *Illinois Bell Telephone Company*, 282 U. S. 133 at 161-2 (1930), or else to assure itself that the revenue received by Phillips in 1954 was typical of the revenue received in the later period. Although Phillips may have incurred an actual loss in 1954, that past loss cannot be recouped in setting rates for subsequent years. *Los Angeles Gas & Electric Corp.* v. *Railroad Commission*, 289 U. S. 287 (1933); *Georgia R. & Power Co.* v. *Railroad Commission*, 262 U. S. 625 (1923); *Galveston Electric Co.* v. *Galveston*, 258 U. S. 388 (1922); see also *F. P. C.* v. *Natural Gas Pipeline Co.*, 315 U. S. 575 (1942).

Even if Phillips' increases had been properly justified on a revenue deficiency basis, however, allowance of these increases would have been improper because of their patently discriminatory nature. The pattern of differentials previously noted in Phillips' rates at the advent of regulation (R. 178) was mirrored in the pattern of increases sought by Phillips in this proceeding; in its application seeking rehearing, Wisconsin pointed out (R. 360) that seven of the twelve rate increase dockets involved increased rates

in excess of the 11.1¢ Commission-determined cost of service. The Commission nevertheless refused to find that this pattern of rate differentials constituted undue discrimination or preference. By authorizing such wildly disparate *increased* rates, the Commission only compounded its error in failing to eliminate the unjustified differentials in *existing* rates, again in violation of the anti-discrimination provisions of the Act. See Point I. C., *supra*, pp. 38-43.

In the final analysis, what the Commission did here was to jettison the Section 4(e) investigation on the basis of 1954 test year data, thereby permitting the continued collection of rates which have never been adequately tested, either as to level or to form, under the standards of Sections 4 and 5 of the Act. The error of such action was accurately described by Judge Fahy in his dissent below (R. 430):

> "The finding of the Commission in the section 4(e) proceedings that there could be no refunds because the cost of service exceeded the revenues on the basis of the data for the 1954 test year, I think does not justify the order terminating all but two of the section 4(e) proceedings, or the Commission's invitation to Phillips to move to terminate all others which are still pending. *The absence of a decision on the issue of justness and reasonableness of rates has the effect of leaving all rates subsequent to 1954 untested under the standards of the Act. Substance is not achieved merely by finding whether or not refunds were due on the basis of the 1954 data.* A finding in that regard should not be independent of a finding of the just and reasonable rates. The former should follow from the fact that the just and reasonable rates are not exceeded by those in effect." (Emphasis added.)

Conclusion.

Petitioners respectfully request that this Court vacate the judgment of the Court of Appeals and remand the case to that court with directions to remand the case to the Federal Power Commission for the purpose of fixing just and reasonable rates *now* for Phillips Petroleum Company on the basis of its costs.

Dated: August 22, 1962.

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APPENDIX A.

Comparison of Average Unit Costs with Average Unit Revenues for All Major Producers whose FPC Rate Cases Have Progressed to Briefing or Decision.

Rank[1]	Producer	Docket	Average Cost[2]	Test Year	Average Revenue per Mcf[3]			Per Cent Increase	1960 Revenue[4]	
					1954	1957	1960	1957-60	Total	Percent Collected Subject to Refund
(1)		(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
	Decided by Commission									
1	Phillips Petroleum Co.	G-1148	11.1¢	1954	8.9¢	10.3¢	14.3¢	38.8%	$90,859,248	22.7%
	Decided by Examiners									
10	Union Producing Co.	G-18354	8.7¢	1958	7.1¢	9.8¢	12.8¢	30.6%	$17,840,692	9.2%
17	Tidewater Oil Co.	G-13310	11.4¢	1957	10.0¢	14.1¢	18.2¢	29.1%	$17,903,668	16.4%
33	Amerada Petroleum Corp.	G-18634	12.2¢	1957	9.2¢	11.7¢	13.5¢	15.4%	$ 5,300,016	7.9%
56	Hunt Oil Co.	G-10414	17.3¢	1957	11.5¢	16.5¢	18.4¢	11.5%	$ 4,736,170	22.7%
	Hearing Concluded (Cost per FPC Staff)									
4	Gulf Oil Corp.[5]	G-17813	9.4¢[6]	1957	9.6¢	11.5¢	15.4¢	33.9%	$29,028,130	16.3%
5	Shell Oil Co.	RI60-111	14.8¢[6]	1959	10.3¢	11.9¢	18.9¢	58.8%	$55,434,867	21.3%
6	Texaco, Inc.	G-8969	8.5¢	1956	10.8¢	15.3¢	17.8¢	16.3%	$31,835,212	9.1%
7	Cities Service[7]	G-12780	8.3¢	1957	10.5¢	11.5¢	13.7¢	19.1%	$22,446,252	9.4%
12	Sun Oil Co.	G-18353	12.3¢	1957	8.6¢	12.0¢	16.0¢	33.3%	$17,524,295	11.3%
15	Continental Oil Co.	G-16966	11.0¢	1955	8.9¢	10.8¢	17.9¢	65.7%	$13,000,859	4.3%
23	Ohio Oil Co.	RI60-92	12.0¢	1958	9.2¢	11.6¢	13.6¢	17.2%	$ 9,797,875	7.6%
60	Sohio Oil Co.	G-18355	15.2¢	1958	9.0¢	9.7¢	19.0¢	95.9%	$ 4,749,664	54.3%
	Weighted Averages		10.9¢[8]		9.2¢	11.5¢	15.7¢	36.5%		16.9%

[1] Rank includes sales made by affiliated companies.

[2] Except for Texaco and Continental, cost figures were derived using methods employed by FPC in its Phillips Opinion.

[3] Cost and revenue figures are not directly comparable, but are included to show approximate order of magnitude.

[4] Excludes revenues from sales made under other producers' rate schedules.

[5] Excludes Warren Petroleum Corp.

[6] Production taxes estimated.

[7] Includes Cities Service Oil Co. and Cities Service Production Co.

[8] Figure is approximate since underlying volume data for each producer are not precisely comparable.

Sources: (1) F. P. C., *Direct Sales by Producers of Natural Gas to Interstate Natural Gas Companies*, 1960.
(2) (3) (4) F. P. C. records.
(5) (6) (7) F. P. C., *Direct Sales by Producers of Natural Gas to Interstate Natural Gas Companies*, 1954, 1957, and 1960.
(9) (10) F. P. C., Form 301A for year ended Dec. 31, 1960.

APPENDIX B

Comparison of FPC Area Price Levels Set Forth in SGP61-1 with Highest Accepted Rate on File with FPC as of September 19, 1960, for Permanently Certificated Sale.

FPC Pricing Area	SGP61-1 Price Level for New Gas	Highest Permanently Certificated Rate as of Sept. 1960*	Comment or Explanation
Texas Dist. 1	15.0¢	14.5¢	
" " 2	18.0	18.0	
" " 3	18.0	20.0	See Note 1
" " 4	18.0	18.0	
" " 5	14.0	—	
" " 6	15.0	14.5	
" " 7B	14.0	10.5	See Note 2
" " 7C	16.0	16.0	
" " 8	16.0	16.0	See Note 3
" " 9	14.0	14.0	
" " 10	17.0	17.0	
So. Louisiana	21.5	22.0	See Note 4
No. Louisiana	17.0	18.5	See Notes 4, 5
Mississippi	21.5	21.5	
Okla.—Panhandle	17.0	17.0	
" —Carter-Knox	16.8	16.8	
" —Other	15.0	15.5	
Kansas	16.0	16.0	
N. M.—Permian	16.0	16.0	See Note 3
" —San Juan	12.7	12.7	See Note 6
Colorado	14.6	16.0	See Note 7
Wyoming	15.0	15.0	

* Excludes rates authorized under temporary authority and rates for sales to commence more than three years in future.

Source: Adapted from F. P. C. Staff Exhibit No. 9 in *Ohio Oil Co.*, G-15385, as expanded and annotated from F. P. C. records.

NOTES

1. Prior to the announcement of the SGP levels in September 1960, the FPC had breached the 18¢ level in District 3 only twice—in *Peoples Gulf Coast*, G-19086, and in *Trunkline*, G-15394. In both instances, certification came after the Public Service Commission of New York had been excluded. New York's exclusion from

Peoples Gulf was subsequently reversed, 295 F. 2d 140 (D. C. Cir. 1961), thereby vacating the 20¢ certification in that case. Although New York's appeal from its *Trunkline* exclusion was dismissed as not timely filed, 284 F. 2d 200 (D. C. Cir. 1960), because of the circumstances surrounding New York's exclusion, the FPC does not regard the Trunkline levels as precedents. See Brief for FPC, pp. 11-18, filed February 12, 1962, in *Hunt et al* v. *F. P. C.*, 5th Cir. No. 19065 et al.

2. District 7B appears to be the only area where the SGP level (14.0¢) departs significantly from the prior high to 1960 (10.5¢). By way of possible explanation, we note the following: (1) by 1960, the 10.5¢ level was quite old, having been established many years previously; (2) very few new sales had been undertaken from District 7B in recent years; and (3) the SGP level for the two neighboring Districts, 7C and 8, is 16.0¢.

3. As of September 1960, the highest permanently certificated *wellhead* price for the Permian Basin of New Mexico and Texas District 8, which adjoins it, was 16.0¢ per Mcf. In August 1959, the FPC had authorized the sale of gasoline plant *residue gas* at 18.0¢ per Mcf, *Transwestern Pipeline Company*, 22 F. P. C. 391; the Transwestern opinion specifically notes that 16.0¢ was the highest wellhead price in the area.

4. The Louisiana prices are shown exclusive of tax reimbursement since this is the way in which they are shown by the FPC's Statement of General Policy. The Southern Louisiana price was modified slightly after the issuance of several Court of Appeals decisions reversing certifications at the level originally stated.

5. The only North Louisiana price in excess of 17.0¢—a single sale by Gulf Oil at 18.5¢—was apparently certificated in error; see Examiner's Decision in *Ohio Oil Co.*, G-15385 (November 8, 1961) Mimeo., pp. 19-21.

6. In addition, the FPC had certificated a 15.9¢ sale in the San Juan Area for *gathered* gas; this price includes a gathering charge of at least 4.4¢. Southern Union Gathering Company Rate Schedule No. 1; see *Southern Union Gathering Company*, G-7670, 14 F. P. C. 1220.

7. Includes 1¢ pressure adjustment. Moran Brothers, Inc., Rate Schedule No. 2.

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No. 73

In the Supreme Court of the United States

OCTOBER TERM, 1962

PEOPLE OF THE STATE OF CALIFORNIA AND PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA,
Petitioners,

vs.

FEDERAL POWER COMMISSION,
PHILLIPS PETROLEUM COMPANY,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

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In the Supreme Court of the United States

OCTOBER TERM, 1962

No. 73

PEOPLE OF THE STATE OF CALIFORNIA AND PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA,
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vs.

FEDERAL POWER COMMISSION, PHILLIPS PETROLEUM COMPANY,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

Brief for Petitioners

OPINIONS BELOW

The opinion of the Court of Appeals, Docket Nos. 16175, 16177 and 16180, issued on November 30, 1961 (R. 410-430) is not yet reported. The Federal Power Commission's Opinion and Order Determining Cost of Service and Terminating Proceeding, issued on September 28, 1960 (R. 251-341), and its Order Denying Applications for Rehearing, Amending Opinion and Rejecting Application for Rehearing, issued on November 25, 1960 (R. 395-404), in the proceeding entitled *In the Matters of Phillips Petroleum Company*, Docket Nos. G-1148, et al., are

reported at 24 FPC 537 (1960) and 24 FPC 1008 (1960), respectively. The decision of the presiding examiner, issued on April 6, 1959 (R. 35-217), in the same proceeding, is reported at 24 FPC 590 (1960).

JURISDICTION

The judgment of the Court of Appeals was entered on November 30, 1961 (R. 431-432). The jurisdiction of this Court is invoked under the provisions of 28 U.S.C. § 1254(1) and Section 19(b) of the Natural Gas Act.[1]

STATUTES INVOLVED

The pertinent provisions of the Natural Gas Act, 52 Stat. 821-833 (1938), as amended, 15 U.S.C. §§ 717-717w (1958), and other statutes involved, are set out in Appendix A to this Brief.

QUESTIONS PRESENTED

(1) Where Sections 4 and 5 of the Natural Gas Act provide a standard of "just and reasonable" for the testing of rates of natural gas producers, may the Federal Power Commission terminate a producer rate proceeding instituted under said statutes and allow the rates at issue to become effective without a finding relative to their justness and reasonableness?

(2) Where the Court of Appeals, affirmed by this Court, has ordered the fixing of rates in accordance with the "just and reasonable" standard of the Natural Gas Act, may the Federal Power Commission, in the remanded proceeding, terminate the proceeding without fixing the rates as so ordered?

(3) Where the cost of service method of regulation is a lawful, established and effective means of regulating natural gas producers, may the Federal Power Commission abandon said method and substitute therefor interim regulation based on administrative fiat while it explores new procedures which it hopes will ultimately satisfy the requirements of the Natural Gas Act?

---

1. 52 Stat. 831 (1938), 15 U.S.C. § 717r(b) (1958). (Appendix A, p. 10.)

(4) Where Sections 4 and 5 of the Natural Gas Act provide for the determination of just and reasonable rates for natural gas producers, may the Federal Power Commission promulgate a list of maximum acceptable rate levels, applicable to said producers, when this list was developed without notice, hearing, and the taking of evidence, and is fraught with practical infirmities?

(5) Where spiral escalation clauses in a natural gas producer's contracts are unacceptable in principle and unlawful in a regulatory setting, may the Federal Power Commission refuse to reject rate increases based thereon?

(6) Where Congress has provided for the regulation of natural gas producers under the Natural Gas Act, may the Federal Power Commission by interminable delay prevent said regulation from becoming a reality and substitute further experimentation for the presently valid standards of regulation?

STATEMENT OF THE CASE

A. ORIGINAL PROCEEDINGS BEFORE THE COMMISSION AND THE COURTS.

On October 11, 1946, the City of Detroit, Michigan, filed a motion with the Federal Power Commission (Commission) requesting that Phillips Petroleum Company (Phillips), an independent producer of natural gas, be declared a natural gas company subject to the Commission's jurisdiction and be made a party to the proceeding entitled *Michigan-Wisconsin Pipe Line Co.*, Docket No. G-669. In acting on this motion, the Commission said:

> "We believe that whether Phillips is or is not a natural gas company cannot properly be determined in this proceeding. If such a determination is required it should be made a separate case after a thorough investigation of Phillips' operations and we therefore find that the motion of the City of Detroit should be dismissed." *Michigan-Wisconsin Pipe Line Co.*, 6 FPC 1, 26 (1947).

On October 28, 1948, the Commission instituted an investigation to determine (1) whether Phillips was a natural gas com-

pany within the Commission's jurisdiction, and (2) if so, whether Phillips' existing rates were unjust and unreasonable. (R. 17-20). This investigation, designated Docket No. G-1148, was initiated pursuant to Section 5(a) of the Natural Gas Act.[2] On January 19, 1950, the State of Wisconsin filed a complaint with the Commission seeking to expedite administrative proceedings respecting Phillips' rates.

Hearings in the investigation commenced on April 3, 1951, and were directed solely to the jurisdictional issue. On August 16, 1951, the Commission found that Phillips was not a natural gas company within the meaning of the Act and, in accordance with this finding, terminated the investigation. *Phillips Petroleum Co.*, 10 FPC 246 (1951).

The United States Court of Appeals for the District of Columbia Circuit, on May 22, 1953, reversed the Commission and ordered it to "fix the rates at which these sales [by Phillips] are made." *State of Wisconsin v. Federal Power Commission*, 205 F.2d 706, 712 (D.C. Cir. 1953). This Court, on June 7, 1954, affirmed the judgment of the Court of Appeals. *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672 (1954).

B. REMANDED PROCEEDING BEFORE THE COMMISSION.

In compliance with the judicial mandate the Commission, on November 23, 1954, resumed its investigation. (R. 407-409). This time the investigation was focused on the second issue—the justness and reasonableness of Phillips' rates.

By later orders the Commission consolidated with the Section 5(a) investigation twelve docketed rate increase filings of Phillips under Section 4(e) of the Natural Gas Act,[3] which increases had been suspended, but at the time were being collected subject to refund.

The new hearings began on June 26, 1956, and were conducted intermittently before a presiding examiner until December 18,

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2. 52 Stat. 823 (1938), 15 U.S.C. § 717d(a) (1958). (Appendix A, p. 3.)

3. 52 Stat. 823 (1938), 15 U.S.C. § 717c(e) (1958). (Appendix A, p. 2.)

1957. The hearings consumed eighty-two days and produced over 20,000 pages of record. (R. 44). Thirty-one parties intervened in the case. Therefore, the Commission's first effort to regulate the rates of a major natural gas producer began eight years after the original order instituting the investigation and eighteen years after the enactment of the Natural Gas Act.

In the course of the proceeding, and in its briefs and oral argument, Phillips took the position that its just and reasonable rates should be determined under the conventional cost of service method. (R. 60). At no time did Phillips contend that the cost approach, as applied in producer rate cases, was unworkable, or that it presented unduly complex problems. On the contrary, Phillips said: "While there was disagreement among the parties with respect to specific matters, there was complete unanimity with respect to many of the fundamental principles which serve as the starting point for any method of cost allocation." (R. 62). In the proceeding Phillips made a comprehensive cost of service presentation of the type consistently introduced in utility rate cases.

C. THE EXAMINER'S DECISION.

On April 6, 1959, the presiding examiner issued a 329 page decision in the consolidated proceeding. At the beginning of his decision the examiner reviewed the court and Commission decisions which he considered governed the case. He quoted paragraphs from *Interstate Natural Gas Co. v. Federal Power Commission*, 331 U.S. 682 (1947), and *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672 (1954). (R. 50-51). Then he observed that "there have been two major Court of Appeals decisions dealing with the broad problem as to how 'just and reasonable' rates should be determined for such producer sales under the Natural Gas Act": *City of Detroit, Michigan v. Federal Power Commission*, 230 F.2d 810 (D.C. Cir. 1955), and *Bel Oil Corp. v. Federal Power Commission*, 255 F.2d 548 (5th Cir. 1958). (R. 51-59). He also cited the Commission's opinion in *Union Oil Co. of California*, 16 FPC 100 (1956), and a number of other

cases to show that "the Commission has consistently held in numerous independent producer rate cases that the conventional rate base method of rate making must be used as a basis of comparison or point of departure." (R. 57)

The examiner then turned to some of the major contentions made by those opposed to the use of the cost of service method for the regulation of producer rates, noting at the outset that "Phillips itself has taken the position throughout this proceeding that its 'just and reasonable' rates should be determined under the cost-of-service method, rather than under a field price method." (R. 60).

To the contention that the four year delay in implementing the Supreme Court's *Phillips* decision is evidence that the cost of service method is unworkable, he replied that it was not until June, 1956, in the present proceeding, that any producer attempted to make "a comprehensive cost-of-service presentation." (R. 63). To the contention that the length of the hearing and record demonstrates its unworkability, he replied that "once the Commission has firmly established the applicable standards and methods to be used in determining producer rates" it will not be necessary to explore alterative proposals on such issues as allocation methods and the treatment of taxes or to present "voluminous general, industry-wide data and material * * *". (R. 64-65).

To an assertion that producers' records do not contain "the type of data required to develop a true cost of service and to make the necessary allocations," the examiner replied that Phillips was able to produce the necessary data and that similar difficulties in regulating pipelines had been solved "by the adoption of such techniques as a Uniform System of Accounts * * *." (R. 65-66). To the contention that allocation problems in connection with joint product wells are "complex," he replied that complex allocation problems had been solved in regulating integrated pipeline companies, and he cited examples. (R. 66-73). He observed further that "[t]he courts have never regarded the cost of service method for regulation of pipeline rates as being unworkable or unsatisfactory because complex allocations were

required, or because such allocations were not susceptible to mathematical exactness." (R. 70-71).

The examiner adopted a system-wide rate approach. Under this approach uniform rates were proposed for all customers, based upon Phillips' system-wide cost of service with rate differentials provided to reflect four different delivery condition factors. These four differential factors were: (1) point of delivery; (2) pressure; (3) whether dehydrated or undehydrated; and (4) whether sweet or sour. (R. 160-161).

The examiner rejected as "unacceptable" the area pricing proposals advanced by the Commission staff and others. (R. 161-180).

In adopting the system-wide rate approach, the examiner concluded that it represents "a satisfactory and appropriate method" for the determination of just and reasonable producer rates for the following reasons:

(1) "It is inherently simple to administer."

(2) "It would be fair to the producer, in the sense that it permits him to recover his total cost of service in one way or another."

(3) "It would eliminate unreasonable preferences currently enjoyed by pipelines which are still purchasing gas under old, abnormally low-priced contracts—preferences which are based not merely upon differences in cost levels, but which reflect other historic reasons."

(4) The examiner said that although a system-wide rate would require pipelines such as Panhandle Eastern Pipe Line Company (Panhandle) and El Paso Natural Gas Company (El Paso), which are presently paying "abnormally low prices," to pay a higher price, this would be only a temporary disadvantage. The examiner stated that such would be "counter balanced" by the fact that their necessary purchases of additional gas reserves from more recently developed and higher cost areas would be made at lower rates than would have resulted under an area pricing method. (R. 186-187).

The examiner stated that "the length and complexity of the instant *Phillips* proceeding cannot fairly be regarded as representative of the situation which will be commonly encountered in future rate proceedings * * *." (R. 65).

The decision called upon Phillips to calculate new rates, based on a cost of service of $57,280,218, for each of its current jurisdictional rate schedules. These "calculated rates", if approved by the Commission, would constitute maximum rates for the consolidated Section 4(e) filings.

The examiner's decision demonstrated that just and reasonable rates could be developed for a producer of natural gas—in this case the nation's largest—on a cost of service basis.

Oral argument was held before the Commission on October 1-2, 1959.

D. THE COMMISSION'S OPINION.

On September 28, 1960, a three member Commission[4] issued Opinion No. 338 (R. 251-341) which reversed the decision of the examiner. The Commission terminated ten of the twelve Section 4(e) rate increase proceedings and the Section 5(a) rate investigation. Phillips was formally discharged from any obligation to make refunds.

The Commission said that its experience with producer rate cases had shown "beyond any doubt" that the cost of service method was "not a sensible, or even workable method of fixing rates of independent producers of natural gas." (R. 256).

"Since the cost rate base method seems almost always to produce the higher rates, it appears that consumers, in most instances, will be thoroughly protected if we place more reliance on existing prices and on applicable economic principles," the Commission said. (R. 265).

4. Participating members were Chairman Kuykendall, Commissioner Stueck and Commissioner Kline. The fourth member, Commissioner Sweeney, joined the Commission after the case was nearly completed, and did not participate. The fifth position on the Commission was vacant at the time.

Pointing to the backlog of producer filings, and considering incoming ones in the years ahead, the Commission concluded that even if the size of its present staff were tripled it could not catch up with its workload until the year 2043. (R. 263).

Besides this administrative burden, the Commission indicated that the cost of service approach "will penalize the efficient or fortunate producer and will unduly reward the inefficient or unfortunate producer." (R. 257). Furthermore, the Commission said, such an approach would result in "the extremely difficult problem" of allocating costs between regulated gas and unregulated oil when they are produced in conjunction. (R. 259).

The Commission observed that where landowners lease land to producers in return for a percentage of the price the producers receive for the products extracted therefrom, the cost approach might encourage leasing to the higher cost producers. (R. 261).

Having made these statements, the Commission abandoned the cost of service method for setting prices. The Commission announced that it would establish prices for the gas itself, and not for each individual producer. (R. 265-269). The ultimate goal as expressed by the Commission, would be:

> "[T]o set prices in all producing areas which will be adequate to maintain the gas supplies needed by the consumers of the nation, but at prices that are no higher than are necessary to accomplish that purpose." (R. 266).

And the Commission added:

> "We fully realize that some persons will contend that the plan of rate regulation we here announce is not lawful and that we are bound by *City of Detroit v. F.P.C.*, 230 F.2d 810 (CADC, 1956), *certiorari denied* 352 U.S. 829, to calculate a rate base and determine a rate of return, at least as a point of departure. If the contention is correct, then, as a practical matter, adequate regulation of producers appears to be impossible under existing law." (R. 267).

Despite the Commission's several contentions as to the drawbacks of the cost approach, it adopted that very approach in the instant proceeding, though not to the point of making a decision.

The Commission explained that it was using cost of service because this was "clearly a lawful way to determine rates for Phillips as illustrated by the *City of Detroit* case, and under the present record is the only possible method, and therefore we shall make every effort to reach a result by this means." (R. 269). Moreover, the Commission said: "In the present proceeding we are as a matter of law permitted to reach results by this method." (R. 270).

The Commission found that Phillips' revenues for the test year 1954 fell about $10,000,000 below the $55,548,054[5] cost of service which the Commission computed for that year. (R. 325-326). Because of this deficiency in revenue, the Commission excused Phillips from making refunds respecting ten of the twelve Section 4(e) increases. This action was taken, the Commission said, because nine of the ten dockets had been superseded by new filings for even higher rates and that the now locked-in rates which were before the Commission should be bypassed. This resulted in putting the proposed increases into effect without setting any rates. As the Commission stated: "[I]t would appear that on the basis of the present record that Phillips' costs probably exceed its revenues at least up through the year 1958, after which very substantial further rate increases were filed by Phillips." (R. 329).

Upon this assumption that Phillips did not recover its cost of service through 1958, the Commission invited Phillips to move to dismiss other Section 4(e) proceedings "on the theory that little or nothing would be accomplished if hearings were held and a determination of Phillips' costs in each case were made." (R. 329). The Commission said this would have the effect of limiting future proceedings dealing with Phillips' rates to the year 1959 and later. Presumably, these later rates would be governed by an area pricing scheme.

Three of the consolidated Section 4(e) dockets concerned rate increase filings based on the activation of spiral escalation

5. On rehearing, this figure was changed to $54,525,315. (R. 400-401).

clauses.[6] Docket No. G-11217, involving a sale to El Paso, and Docket No. G-10883, involving a sale to Panhandle, were left open pending the final determination of the rates of these pipeline companies in other proceedings. However, the rate increase in Docket No. G-10793, covering a sale to Michigan-Wisconsin Pipe Line Company, was approved by the Commission. (R. 328-329). By keeping the former open only on the issue of the amount of increase and by approving the increase in the latter, the Commission placed a stamp of legality on spiral escalation clauses.

The Section 5(a) general investigation of all of Phillips jurisdictional sales was terminated without decision because the Commission did not "think that it is appropriate to set rates for the future on the basis of this record in this hearing that terminated December 18, 1957, utilizing a test year of 1954 or 1956 * * *" (R. 271), and because Phillips' "customers and consumers will receive the protection of our area pricing standards announced at this time" (R. 325).

The Commission disapproved of Phillips' spiral escalation clauses "in principle" yet refused to declare them void in this proceeding. (R. 327).

One Commissioner dissented, but only with respect to the manner in which the cost of service was computed.

The Commission's Statement of General Policy—In accordance with its opinion, the Commission simultaneously issued its Statement of General Policy No. 61-1 (Policy Statement). (R. 343-348). The Policy Statement is concerned not only with producer matters under Sections 4 and 5, but also producer certificates of public convenience and necessity under Section 7 of the Act.[7] It divides part of the continental United States into several producing areas, with two price guides or "maximum acceptable rates" for each area. (R. 344). One price is for new

6. Spiral escalation clauses are discussed in detail on pp. 56-61. See also Appendix B, this Brief.

7. 52 Stat. 824 (1938), 15 U.S.C. § 717f (1958). (Appendix A, p. 4).

sales which must be certificated under Section 7. The other price is for increases under existing contracts. Prices on new sales will be conditioned if they do not conform to the area price for new gas; price escalations in existing contracts will be suspended if they do not conform to the area price for established service.

The Policy Statement provides for area rate proceedings wherein parties may challenge the price levels or the geographical makeup of the area. (R. 346-347). The Commission did not disclose the basis for the particular levels and said only that the Policy Statement was "based on our experience gained after six years of regulation of independent producers under the Natural Gas Act." (R. 343).

E. THE ORDER DENYING REHEARING.

California filed a timely petition for rehearing on October 28, 1960 (R. 363-370), which was denied by the Commission on November 25, 1960. (R. 395-404).

In the order denying rehearing the Commission said it terminated the proceedings without making the finding as to the justness and reasonableness of Phillips' rates as required by Sections 4 and 5

> "because we did not believe we were supported by the record in doing so [making a finding], and we were of the opinion that the public interest did not justify our continuing these proceedings. In the first place we are given discretion as to whether to initiate proceedings either under Section 5(a) and Section 4(e). * * *
>
> "Just as the statute leaves us with discretion as to whether to initiate proceedings, we have authority to discontinue the proceedings. Regulation under the Natural Gas Act is carried on in the public interest (Section 1(a)), and there is no obligation to continue these proceedings to the point of making a definitive finding with respect to Phillips' rates, where the public interest is not served." (R. 395-396).

The Commission concluded:

> "[T]he attempt here to regulate Phillips' rates on an individual company basis has proved cumbersome and inexact.

> It has demonstrated however, that there is no public interest in continuing the Section 4(e) proceedings, which are largely concerned with past periods. Furthermore, because of the lapse of time, the 1954 cost of service determined by us is not appropriate for the future. The more recent rate increases filed with us have been suspended under Section 4(e), and they will be subject to the new area methods of regulation discussed in our Policy Statement." (R. 397).

The Commission refused to rule that the spiral escalation clause in Phillips' contracts were void as against public policy.

F. PROCEEDING IN THE COURT OF APPEALS.

Pursuant to Section 19(b) of the Natural Gas Act,[8] California obtained court review of the Commission's opinion and the order denying rehearing.

The court, with Judge Fahy dissenting with partial concurrence, upheld the Commission's position that the cost of service method of regulation is not a sensible, or even workable, means of fixing producer rates. (R. 414). It pointed out, as did the Commission, that cost of service, by limiting producers to a fair return on investment, penalizes efficient or fortunate producers who have low costs. (R. 414). The method, the court said, produces problems in the allocation of costs between gas and oil and is a burden on the administrative agency. (R. 414-415). Nevertheless, the court agreed with Phillips' cost of service as computed by the Commission. (R. 419-420).

The court divided the proceeding into three parts. The first part of the problem, as the court saw it, concerned the nine Section 4 (e) dockets which had been superseded, or locked-in, by a new series of rate increase proposals.[9] The court said:

> "In these 4(e) cases * * * the Commission was dealing with a locked-in period. The revenues derived from the

8. 52 Stat. 831 (1938), 15 U.S.C. § 717r(b) (1958). (Appendix A, p. 10).

9. The court also included within this grouping a tenth docket, G-8623, which had not been superseded by a filing for a higher rate. (R. 325).

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> rates at issue had been impounded. The only question of substance in respect to that period was whether refunds should be made." (R. 419).

Accordingly, the court concluded that the Commission's action in terminating these dockets was a clear decision, after elaborate findings, upon the issue of refunds. (R. 420). The court further said that "[w]hether the Commission should have preceded its ultimate conclusion of no-refund with an intermediate conclusion of justness and reasonableness in the rates at issue, and whether it properly added the termination order to its decisive finding, seem to us to be immaterial queries." (R. 420).

The second part of the problem was what the court called "the determination of rates for the future." (R. 421). The court found that the Commission was justified in abandoning the Section 5(a) investigation "in which it had been endeavoring to establish rates for the future by methods it now deems inadequate." The court also approved the inauguration of the area pricing scheme. (R. 421).

The third and final part, in the court's view, was the "interim period" from January 1, 1959, to a date uncertain when the area pricing of gas is ultimately established. (R. 421-422). It is acknowledged that this period may last as long as fourteen years. (R. 422). To carry on its duties during this period, the court said that the Commission could rely on the rates established by the Policy Statement. The court expressed the problem this way:

> "Can [the Commission] adopt upon the basis of its own expertise and its files, without a record made in the open in respect to the specific subject matter in issue, and without hearing, a set of guide lines by which it will be controlled in its regulatory functions during an interim period which it is attempting to perfect a suitable system for permanent regulation? We think it can." (R. 422).

On the question of the legality of Phillips' spiral escalation clauses, the court said:

> "Wisconsin and California contend that the Commission should now declare these escalator clauses to be illegal and

> void as against public policy. As a matter of fact the Commission has declared these clauses to be against the public interest and that they should be held inoperative. But, the Commission says, insofar as these clauses of Phillips are concerned, action of the sort demanded by Wisconsin and California is premature. Action on these clauses, it says, should await action on the pending cases which in orderly processes present the problem for decision. We agree with the Commission." (R. 426-427).

The court was referring to the spiral escalation clauses in Dockets Nos. G-11217 and G-10885, which dockets were left open on the issue of the amount of increase only. The court made no reference to the spiral escalation clause in Docket No. G-10795, which docket was not left open but was terminated along with the other Section 4(e) proceedings.

The dissenting opinion did not agree that the termination of the Section 4(e) and the Section 5(a) proceedings should be affirmed. The dissenting judge said: "I think the cases should be remanded to the Commission for decision." (R. 427). On the cost of service issue, Judge Fahy noted:

> "In the same breath as it were in which it describes the unworkability of the cost of service method the Commission itself accepts that precise method in finding that no refunds are to be required in the Section 4(e) proceedings * * *." (R. 427-428).

Speaking of the Commission's proposal to establish commodity pricing of gas on an area basis, he said:

> It is one thing to say, as the Commission does, that the area method should hereafter be adopted, or even adopted in other cases which have not proceeded as far as those before us. It is quite another thing to say that the latter should not be decided under the standards of the Act because the area method was not used in preparing the record. Unless decided Phillips challenged rates are left undetermined under the standards of the Act since 1948, and apparently will continue to remain undetermined until some future day when new proceedings, now in an inchoate status with no end in sight, are concluded." (R. 429).

The dissent insisted that the primary purpose of the Natural Gas Act, that is, consumer protection, can be achieved by remanding the proceeding to the Commission, and supplementing the record as necessary. The dissent said:

> "The absence of a decision on the issue of justness and reasonableness of rates has the effect of leaving all rates subsequent to 1954 untested under the standards of the Act. Substance is not achieved merely by finding whether or not refunds were due on the basis of the 1954 data. A finding in that regard should not be independent of a finding of just and reasonable rates. The former should follow from the fact that the just and reasonable rates are not exceeded by those in effect." (R. 430).

The dissent concurred with the majority only as to the prematurity of the request for action relating to the spiral escalation clauses.

G. CALIFORNIA'S INTEREST IN THE CASE.

California's interest in this proceeding stems from its unique dependence upon natural gas as a fuel. Since California does not possess coal deposits sufficient for its energy requirements, it is compelled to rely upon natural gas. Ninety per cent of all homes in California are heated by natural gas and California industry depends upon natural gas as a fuel.

California commenced importing natural gas from out of state sources in 1947. In 1961 it purchased 765,483,478,000 cu. ft. of gas from El Paso at a cost of $257,854,417.54.[10] This represented over 80 per cent of El Paso's operating revenues. In the same year El Paso purchased 248,920,469,000 cu. ft. from Phillips at a cost of $38,732,594.75.[11]

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10. Annual Report of El Paso Natural Gas Company to Federal Power Commission for Year Ending December 31, 1961, FPC Form #2, Sales for Resale—Natural Gas (Account 483), pp. 521-522.

11. Annual Report of El Paso Natural Gas Company to Federal Power Commission for Year Ending December 31, 1961, FPC Form #2, Gas Purchases (Accounts 800-805), pp. 535-536.

From 1947 to 1960 the average producer price paid by El Paso increased from 2.8 cents per Mcf to 15.8 cents per Mcf, or almost 400 per cent.[12] Today the producer price makes up a substantial portion of the final price paid by the ultimate California consumer.

California ratepayers, numbering over 4,000,000, have a substantial interest in the effective regulation of Phillips, and of producers generally. California estimates that by 1970 it will be importing 1,825,000,000,000 cu. ft. of natural gas annually to serve an expanded population. The cost of this huge quantity of fuel will depend, as it does now, upon effective regulation of prices at the wellhead.

SUMMARY OF ARGUMENT

The primary purpose of the Natural Gas Act is the protection of consumers from exploitation at the hands of natural gas companies. In rate cases, like the instant proceeding, the Act is designed to afford consumers a complete, permanent and effective bond of protection from excessive rates and charges.

In 1954, this Court found that the Commission had jurisdiction, under the Act, to regulate the rates of independent producers of natural gas who sell their product for resale in interstate commerce, and ordered the Commission to undertake such regulation. The Commission, however, has not complied with this mandate; rather, it has offered indecision, indifference and delay as alternatives to the effective regulation which this Court ordered. As a result of the Commission's inaction, consumers of natural gas have not received the protection to which they are entitled.

The instant proceeding was terminated without a finding on the substantive issue before the Commission—the justness and reasonableness of Phillips' rates—even though the Commission had conducted the case to the point of receiving an examiner's decision and hearing oral argument on the issue presented. This termina-

12. Annual Reports of El Paso Natural Gas Company to Federal Power Commission, 1947-1960, FPC Form 2, Gas Purchase Accounts 715.11 and 715.12 (excluding exchange gas) (Permian Basin).

tion was contrary to the judicial mandate to fix the rates at which Phillips' jurisdictional sales are made.

In terminating the proceeding, the Commission erred in abandoning the cost of service method of regulation. Cost of service is a lawful, established and effective means for determining just and reasonable rates for producers under the Natural Gas Act, and it has been consistently used by the Commission and repeatedly approved by the Courts. It was the conventional form of regulation at the time the Natural Gas Act was enacted, and the Act is specifically designed for its use. Furthermore, by assuring producers the recovery of their costs through rates, as well as providing a return on investment, it guarantees the producers their constitutional rights.

As a substitute for cost of service regulation the Commission visualized the eventual establishment of the commodity pricing of gas on an area basis. This, it recognized, may take as long as fourteen years. In the meantime, the Commission will operate under a so-called Policy Statement which was promulgated without notice, hearing, and taking of evidence, and which is subject to revision at any time in like manner. The maximum acceptable rates announced in the Policy Statement are admittedly not promulgated as just and reasonable rates and, therefore, are not necessarily lawful rates within the meaning of the Act.

The Policy Statement is fraught with practical difficulties in that it has the effect of raising otherwise lower rates to the established commodity price levels. It is also ineffective because of the right of producers to file for rate increases at any time regardless of these levels.

The Commission further erred in perpetuating the existence of the spiral escalation clauses in Phillips' contracts, even though the Commission itself was opposed to them in principle. These clauses, causing consumer price increases which are unrelated to the factors involved in producing gas, permit the exploitation of consumers in contravention of the Natural Gas Act.

Consumer protection requires that there be effective regulation of prices at the production end of the natural gas industry. The

decision of the Court of Appeals and the opinion of the Commission fail to provide such effective regulation and, accordingly, they must be set aside.

ARGUMENT

I.

Independent Producers Are Not Exempt From the Established Standards of Regulation Under the Natural Gas Act.

The Commission's opinion commences with this language: "This is a rate proceeding under Sections 4 and 5 of the Natural Gas Act * * *." (R. 251). But as the opinion develops it becomes quite clear that the Commission's approach is far different from that found in the usual rate decision in the usual rate proceeding. For the Commission's opinion takes the form of a bill of particulars as to why it cannot decide the case by known and established procedures and why it must terminate the proceeding before it and make a new start in other proceedings. (R. 256-269, R. 323-326)

A divided Court of Appeals recognized the instant case as one involving "major problems of general application" and posing "complicated procedural difficulties." (R. 411).

California, intervenor before the Commission and petitioner in the court below, has never characterized this case as being any more than a rate case that should be decided under the standards established by the Natural Gas Act. However, California does emphasize the paramount importance of this proceeding, for involved here are the rates of the largest natural gas producer in the nation and the procedures that will govern natural gas producers generally.

California contends that the Commission unlawfully used the instant proceeding as a vehicle for establishing rates and practices which are contrary to the Natural Gas Act and for approving contract provisions which are repugnant to public policy.

In Section 1(a) of the Natural Gas Act[1] the Congress made

[1] 52 Stat. 821 (1938), 15 U.S.C. § 717(a) (1958). (Appendix A, p. 1).

known the compelling reason for federal regulation of the natural gas industry:

> "As disclosed in reports of the Federal Trade Commission made pursuant to S. Res. 83 (Seventieth Congress, first Session) and other reports made pursuant to the authority of Congress, it is declared that the business of transporting and selling natural gas for ultimate distribution to the public is *affected with a public interest*, and that Federal regulation in matters relating to the transportation of natural gas and the sale thereof in interstate and foreign commerce is *necessary in the public interest*. (Emphasis supplied).

In natural gas regulation the public interest requires consumer protection. While the segments of the natural gas industry which produce, sell and transport this natural resource are constitutionally entitled to protection against confiscation, as are public utilities, the underlying basis of the congressional regulatory scheme is the protection of the consumer.

This Court emphasized that the primary aim of the Act is "to protect consumers against exploitation at the hands of natural gas companies." *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 611 (1944); *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672, 685 (1954).

This purpose was reaffirmed in *Sunray Mid-Continent Oil Co. v. Federal Power Commission*, 364 U.S. 137, 147 (1960), and rephrased in *Atlantic Refining Co. v. Public Service Commission of the State of New York*, 360 U.S. 378, 388 (1959): "The Act was so framed as to afford consumers a complete, permanent and effective bond of protection from excessive rates and charges." See also *Federal Power Commission v. Transcontinental Gas Pipe Line Corp.*, 365 U.S. 1, 19 (1961).

This standard of consumer protection must be weighed against the action of the Commission in this proceeding. Having determined Phillips' cost of service, the Commission said "the next step would ordinarily be to alter Phillips' rates to reflect this cost of service." (R. 323). But the Commission did not take this step.

Instead, the Commission took notice that Phillips had filed, since the instant proceeding began, for even higher rates, some involving "substantial increases." (R. 324). The Commission also noted that "costs and prices of gas in the field have greatly increased" since the proceeding commenced, though there is no record basis for this observation. (R. 324). The Commission concluded that it was "not appropriate" to continue its Section 5(a) general investigation now that the record was so old. (R. 324).

In brief, the Commission said: We will not decide whether the rates before us are proper under the Act because Phillips has filed for higher rates and, when the time comes, we will decide if those higher rates are proper. This reasoning is analogous to this Court saying: We will not decide this case because a case will arise in the future with the same issues, and we will decide that case at that time.

The termination, the Commission said, will not "substantially" injure Phillips' customers because Phillips' rates will be "subject to our continuing surveillance * * *". (R. 325). And the Commission added:

> "Additionally [Phillips'] customers and consumers will receive the protection of our area pricing standards announced at this time. Phillips will not be injured, for we are thus leaving in effect its contract structure; it has had the privilege of filing increased rates and has done so in substantial amounts as already noted." (R. 325).

It should be noted that the Commission said customers "will not be *substantially* injured" and Phillips "will not be injured." (Emphasis supplied). Thus, the Commission tipped the scales away from the standard of consumer protection.

The Section 4(e) dockets were terminated because "these rates have produced revenues less than Phillips' cost of service during the periods that they were in effect." (R. 325-326). Nothing of this sort was ever demonstrated because the particular rates were not altered to reflect the cost of service. (R. 326). What was shown was that the company's revenues were less than costs in

the test year. The mere fact that the company's over-all gas operations did not result in sufficient revenues does not mean that the rates themselves must be just and reasonable. By this reasoning Phillips could charge 1¢ per Mcf in one contract and $1.00 per Mcf in another contract, and if this caused a deficiency in revenues, then both rates would be just and reasonable. How then would those consumers who feel the impact of the $1.00 price, and not the effect of 1¢ price, be protected?

Continuing surveillance and a proposed area pricing scheme are not the complete, permanent and effective bond of protection to which consumers are entitled. Consumer needs are present, not future. Natural gas is a commodity which is being consumed daily by the industry of America and by its people. The clear intent of Congress in providing for protection against exploitation was present protection, not a deferral to some future providence. Consumer protection demands that the Commission decide the cases at issue before it, and decide them with due consideration to the injury they may cause to the ultimate ratepayers.

Congress has provided a standard, applicable to all natural gas companies, to enable the Commission to protect consumers. Section 4(a)[14] sets forth that standard:

> "All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission * * * shall be *just and reasonable*, and any such rate or charge that is not *just and reasonable* is hereby declared unlawful." (Emphasis supplied).

In *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 611 (1944), the Court found this section to be the "heart" of the whole regulatory scheme, and the pulsation of this heart must be heard in all rate proceedings, for this is what gives vitality to the regulatory process.

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14. 52 Stat. 822 (1938), 15 U.S.C. § 717c(a) (1958). (Appendix A, p. 1).

The captive consumer has no effective means by which he can escape the incidence of unjust and unreasonable prices. If he wants gas, he must accept the price set by the local distributing utility. The residential consumer cannot turn to other fuels without discarding his expensive gas appliances; the industrial consumer is often limited to natural gas by local air pollution regulations.

In California, the price fixed for the distributing companies is largely dependent on the price charged by El Paso, the major exporter of gas to California. El Paso buys a substantial portion of its supplies from Phillips. The Phillips' price, then, is critical to California. If it is not just and reasonable, its injurious impact is felt in California.

The Commission's action in terminating the instant proceeding, without determination of the issue of the lawfulness of rates, has the effect of exempting Phillips, and other producers, from the standards of consumer protection and just and reasonable rates, which are imbedded in the Natural Gas Act and enunciated by this Court.

II.

The History of Independent Producer Regulation Is One of Indecision, Indifference and Delay.

For a period of about sixteen years—from 1938, when the Natural Gas Act was enacted, until 1954, when independent producer regulation was ordered by this Court—the Commission regulated the rates of natural gas companies on the cost of service basis.[15] The cost of service method allows a natural gas company to recover its operating costs, including taxes, plus a return on its original investment, less depreciation. During this period the Commission persisted in the view that only interstate pipeline companies were natural gas companies and, consequently, only

15. The leading cases were: *Canadian River Gas Co.*, 3 FPC 353 (1942); *City of Cleveland v. Hope Natural Gas Co.*, 3 FPC 350 (1942); *Interstate Natural Gas Co.*, 3 FPC 416 (1943); *Cities Service Gas Co.*, 3 FPC 459 (1943); *El Paso Natural Gas Co.*, 13 FPC 421 (1954).

some thirty-seven major pipelines were included within the scope of natural gas regulation.

On November 17, 1954, almost six months after this Court's decision in the *Phillips* case, the Commission issued a notice of proposed rule making entitled "Consideration of Principles and Methods to be Applied in the Fixing of Rates to be Charged by Independent Producers of Natural Gas Sold in Interstate Commerce for Resale," Docket No. R-142, 13 FPC 1524 (1954). The Commission invited written comments and heard oral argument, but over twelve months later it terminated the proceeding without adopting a method indicating that such would have to come through a consideration of individual cases:

> "However, the information gained in this proceeding convinces us that, on the basis of the record herein, we should not lay down any rules as to what would be necessary or appropriate for consideration in determining the just and reasonable rates of any independent producer subject to our jurisdiction under the Natural Gas Act." 14 FPC 1128, 1129 (1955).

The attitude expressed there, seven years ago, rings familiar to the attitude which inconclusively terminated the instant proceeding.

In the first opinions issued in independent producer rate cases the Commission refused to announce any substantive rules of general application, thereby indicating its indecisiveness. For example, in *Wunderlich Development Co.*, 15 FPC 690, 693 (1956), the Commission said:

> "We do not pass on the question of whether evidence of the character now before us would in any other case substantiate a given rate as just and reasonable."

In *Davidor and Davidor*, 15 FPC 1236, 1238 (1956), this attitude is again shown:

> "We cannot say, in view of the uncertain and nebulous state of the applicable law, that proof of the character here submitted would justify a rate increase in all or any other similar case."

These decisions are startling because the Commission was not without guidance. In *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 616 (1944), this Court, referring to the method of regulation under the Natural Gas Act, said:

> "The Committee Report stated that the Act provided for regulation along recognized and more or less standardized lines and that there was 'nothing novel in its provisions.'"

The *Hope* case upheld the Commission's use of a net original cost rate base plus operating expenses, with no allowance for the value of gas as distinguished from the cost of production, in regulating the rates of a natural gas company engaged in *both production and transmission*.

The Commission itself, in *El Paso Natural Gas Co.*, 15 FPC 421, 426 (1954), had said that the rates for both independent producers and for pipeline companies' own production should be fixed in the same manner.

But the alarming element of the Commission's indecision is that the first independent producer rate cases were decided subsequent to the Court of Appeals decision in *City of Detroit, Michigan v. Federal Power Commission*, 230 F.2d 810 (D.C. Cir. 1955), cert. denied 352 U.S. 829 (1956). There the court had said, at page 818:

> "[Cost of service] has been repeatedly used by the Commission, and repeatedly approved by the courts, as a means of arriving at lawful—just and reasonable—rates under the Act. *Unless it is continued to be used at least as a point of departure*, the whole experience under the Act is discarded and no anchor, as it were, is available by which to hold the terms 'just and reasonable' to some recognizable meaning." (Emphasis supplied.)

Instead of following the guiding principles of the *City of Detroit* case, the Commission reacted against them. Typical of this reaction is the testimony of then Commission Chairman Kuykendall (one of the authors of the opinion in the instant proceeding) before a House Appropriations subcommittee:

> "CHAIRMAN KUYKENDALL: * * * I would say this, and with all due respect to the circuit court of appeals, I think that the court was in error when it told us we had to have an original cost study of each producer."[16]

With this indifference toward the guidelines pointed out to it by the courts, and toward its own prior experience in regulation, the Commission on June 26, 1956—two years after this Court's decision in the *Phillips* case—commenced hearings in the instant proceeding. It is interesting to note that the hearings were conducted along the cost of service lines called for by the *City of Detroit* case. And it was thought that the Commission would also follow that path to a decision when, in an order denying rehearing, it said:

> "What [Section 4] does require is the presentation of rate base and cost evidence as a point of departure plus a showing that any additional allowance is no more than is reasonably necessary for the purposes advanced for any increase." *Union Oil Co. of California*, 17 FPC 89, 91 (1957).

The Commission followed no path at all. In 1960 it terminated the instant proceeding with the result that producer regulation was set back to its 1954 status. Adding this six-year period to the sixteen years from 1938 to 1954, and adding to this total the time it has taken to bring this proceeding to this Court, it will soon be the twenty-fifth year in which the consumers of the nation have gone without the type of regulation demanded by the Natural Gas Act.

No discussion of Commission indecision, indifference and delay is complete without reference to other aspects of the Commission's reluctance to regulate independent producers.

The Commission has never established a uniform system of accounts and records for independent producers of natural gas. This Court has commented on the indispensability of such systems to effective regulation. *Interstate Commerce Commission v. Good-*

16. Hearings on the Independent Offices Appropriations for 1957, House subcommittee, February 20, 1956, at p. 1727.

rich Transit Co., 224 U.S. 194, 211 (1912); *Kansas City So. Ry. Co. v. United States*, 231 U.S. 423, 440 (1913). Moreover, this Court recognized the Commission's authority to prescribe uniform systems of accounts in *Northwestern Electric Co. v. Federal Power Commission*, 321 U.S. 119 (1944), and in *Federal Power Commission v. East Ohio Gas Co.*, 338 U.S. 464 (1950).

The thousands of independent producers, making up the largest single group within the Commission's jurisdiction, have not been subjected to a comprehensive uniform system of accounts and records even though the Commission recognizes the necessity of this for effective regulation. *The East Ohio Gas Co.*, 6 FPC 176, 183 (1947).

California, upon the apparent expectation that the Commission itself would act on this matter, did not formally request the Commission to enact such a system. However, on July 9, 1962, California filed with the Commission a Petition to Establish a Uniform System of Accounts and Records for Independent Producers of Natural Gas, which has been designated as Docket No. R. 220.

Another aspect of the Commission's disinclination toward producer regulation is the active support which it has given to legislation exempting producers from regulation, including the Harris-Fulbright Bill[17] which was vetoed by President Eisenhower in 1956.

The Court of Appeals' decision in the instant proceeding has only further delayed effective producer regulation. The court below spoke of the regulation of producers as a "new project." (R. 421). Furthermore, the court asked the nation to wait "four to fourteen" years more for the type of regulation which the Commission thinks will be desirable. (R. 422).

As already indicated, producer regulation is not a new project and the nation has already waited a quarter of a century for some action. The Commission could openly defy the judicial mandates and the dictates of the Natural Gas Act, but without success, if it were to announce its outright refusal to regulate the production

17. H.R. 4560, 84th Cong., 1st Sess. (1955); H.R. 6645 84th Cong., 1st Sess. (1955) (amended bill); S. 1853, 84th Cong., 1st Sess. (1955).

of natural gas. California asks whether or not interminable administrative indecision, indifference and delay are not tantamount to a refusal to regulate.

One of the greatest dangers of the administrative process is that an agency, through lethargy or other reasons, can thwart the aim of the legislation it is obligated to administer. This Court urged an agency to act "as quickly as is consistent with good administration." *National Labor Relations Board v. Electric Vacuum Cleaner Co.*, 315 U.S. 685, 698 (1942). See also *Smith v. Illinois Bell Telephone Co.*, 270 U.S. 587, 591-592 (1926).

Shortly after the Commission's opinion was issued in the instant proceeding, a special report to President-elect Kennedy on the regulatory agencies was released.[18] The document was prepared by James M. Landis, formerly dean of the Harvard Law School and formerly chairman of both the Securities and Exchange Commission and the Civil Aeronautics Board. The report is sharp in its criticism of the Commission. It states:

> "The Federal Power Commission without question represents the outstanding example in the federal government of the breakdown of the administrative process. The complexity of its problems is no answer to its more patent failures. These failures relate primarily to the natural gas field, in the Commission's handling of its responsibilities with respect to the transmission and the production of natural gas. Enough has already been said about the delays in this field, so terribly costly to the public and so productive of unemployment in other basic industries."

The Commission's dread of producer regulation is without foundation. For over twenty-four years the Commission has had subject to its jurisdiction and has regulated a large number of pipeline companies which are engaged in the exploration, development and production of natural gas in most of the same areas and fields in which producers conduct their operations. Moreover,

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18. Report on Regulatory Agencies to the President-elect, submitted by the Chairman of the Subcommittee on Administrative Practice and Procedure to the Committee on the Judiciary of the United States Senate (December, 1960).

many of these companies have producing-company subsidiaries or affiliates. It is difficult to understand the Commission's reluctance to do the full job in producer cases when it has been doing the same work for years in integrated pipeline cases.

III.

The Proceeding Was Unlawfully Terminated.

A. THE PROCEEDING CANNOT BE LAWFULLY TERMINATED WITHOUT A FINDING RESPECTING THE JUSTNESS AND REASONABLENESS OF PHILLIPS' RATES.

The Commission's Section 5(a) investigation was intended to be an examination of all of the jurisdictional rates of Phillips for the purpose of determining the lawfulness of such rates. The Section 4(e) proceedings were for the purpose of deciding whether the rates demanded in particular dockets were lawful rates. A lawful rate is any rate or charge that is just and reasonable. Section 4(a).

Section 5(a) fits into the scheme of natural gas regulation as a means, first, of determining the justness and reasonableness of existing rates and, second, of fixing just and reasonable rates for the future if existing rates are, in fact, not just and reasonable. Section 4(e), being less broad, is concerned with the justness and reasonableness of rates contained in specific filings. See *Atlantic Refining Co. v. Public Service Commission of the State of New York*, 360 U.S. 378, 388-389 (1959).

California insists that a finding as to justness and reasonableness is required in the instant proceeding. It is immaterial whether the Commission uses the words "unjust and unreasonable," "just and reasonable," "not just and reasonable" or "not unjust and unreasonable." California does not insist on a verbal formula. The finding that the statutes demand is one relative to the justness and reasonableness of the rates at issue. If existing rates are just and reasonable, the Section 5(a) investigation must be decided with such a finding; if the same rates are unjust and unreasonable, a finding to that effect must be made, with the Commission further obligated to fix rates for the future. If the rates involved in the

Section 4(e) dockets are just and reasonable, or the contrary, they must be so found.

In its order denying rehearing the Commission said it was under no obligation to make "a definitive finding with respect to Phillips' rates * * *." (R. 396). The court below adopted this view. The court held that the making of such finding was unnecessary in the Section 5(a) investigation because the Commission could not continue the proceeding using "methods it now deems inadequate" (R. 421); and it was unnecessary in the Section 4(e) dockets because the only question of substance there was "whether refunds should be made" (R. 419). The court said:

> "Whether the Commission should have preceded its ultimate conclusion of no-refund with an intermediate conclusion of justness and reasonableness in the rates at issue, and whether it properly added the termination order to its decisive finding, seem to us to be immaterial queries." (R. 420).

In opposition to this position it must be pointed out, first, that an agency, such as the Commission, cannot take action without making the findings required by statute. *Mahler v. Eby*, 264 U.S. 32, 44-45 (1924); *City of Yonkers v. United States*, 320 U.S. 685, 689 (1944). The necessity for such findings has been discussed by this Court in *Colorado-Wyoming Gas Co. v. Federal Power Commission*, 324 U.S. 626, 631, 634 (1945):

> "Here as in the cases of Canadian and Colorado Interstate the findings of the Commission leave much to be desired. The findings are general and incorporate by reference the staff exhibits, on which reliance is put for the subsidiary findings. * * *
>
> "The review which Congress has provided for these rate orders is limited. Section 19(b) 15 USCA Sec. 717r(b) 4 FCA title 15, Sec. 717r(b) says that the 'finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive.' But we must first know what the 'finding' is before we can give it conclusive weight. We have repeatedly emphasized the need for clarity and completeness in the basic or essential findings on which administrative orders rest. Florida v. United States, 282 US 194, 215, 75

> L ed 291, 304, 51 S Ct 119; United States v. Baltimore & O R. Co., 293 US 454, 464, 79 L ed 587, 594, 55 S Ct. 268; United States v. Chicago, M. St. P. & P. R. Co., 294 US 499, 504, 505, 510, 511, 79 L ed 1023, 1028, 1029, 1031, 1032, 55 S Ct 462; United States v. Carolina Freight Carriers Corp., 314 US 475, 488, 489, 86 L ed 971, 982, 62 S Ct 722. Their absence can only clog the administrative function and add to the delays in rate making. We cannot dispense with them for Congress has provided the standards for judicial review under this Act. Sec. 19(b). The courts cannot perform the function which Congress assigned to them in absence of adequate findings. Nor are they authorized under Sec. 19(b) to make findings and substitute them for those of the Commission."

Not only do the Natural Gas Act and the courts require findings but also the Administrative Procedure Act. Section 8(b)[19] of that Act requires that "All decisions * * * shall * * * include a statement of (1) findings and conclusions, as well as reasons or basis therefor, upon all material issues of fact, law, or discretion presented on the record; and (2) the appropriate rule, order, sanction, relief, or denial thereof." In the instant proceeding, Judge Fahy's dissent pointed to the absence of a finding on the issue of justness and reasonableness of the rates (R. 430), and concluded the case must be remanded to the Commission for that finding (R. 427).

Secondly, the court below and the Commission, by making the determination of refunds the primary question in a Section 4(e) docket, ignore the literal language of that section. Section 4(e) is designed to consider the lawfulness, that is, the justness and reasonableness, of filed rate increases. The provision for refunds, contained therein, is merely a means of accounting for amounts collected under thes filed rate increases while the issue of lawfulness is pending befo: the Commission in suspension cases only. Until a decision on the lawfulness of rates is made, the Commission cannot possibly know if any monies must be refunded.

19. 60 Stat. 242 (1946), 5 U.S.C. § 1007(b) (1958). (Appendix A, p. 12).

The substantial prejudice resulting to California from this insufficiency in findings is apparent. California has participated in this prolonged administrative proceeding to its great expense in time, energy and money. While this proceeding was in the hands of the Commission, rate increase was stacked upon rate increase, through no fault of California. California is entitled to a decision on the justness and reasonableness of the rates which were before the Commission; California should not be required to wait for new proceedings which will consider only Phillips' new rates.

Most importantly, this Court, in *Atlantic Refining Co. v. Public Service Commission of the State of New York*, 360 U.S. 378, 391 (1959), has allowed the Commission, under Section 7 of the Natural Gas Act, to certificate initial prices in new sales by independent producers if they are not "out of line" with established price plateaus. The prices of Phillips, made effective by the order of termination in this proceeding, go into the price line which guides the Commission in Section 7 proceedings. By allowing prices that are untested under the standard of just and reasonable to enter the line can only distort the line, if not make it meaningless.

B. THE PROCEEDING CANNOT BE LAWFULLY TERMINATED ON THE BASIS OF UNLIMITED DISCRETION TO SO ACT.

The termination of the Sections 5(a) and 4(e) proceedings is controlled by *Minneapolis Gas Co. v. Federal Power Commission*, 294 F.2d 212 (D.C. Cir. 1961), where the court below found that the Commission had no discretionary authority to terminate a rate proceeding, without deciding it, after the examiner had rendered an initial decision, the parties had filed exceptions, and the Commission had heard oral argument. The decision in the instant case is clearly inconsistent with that holding. In the *Minneapolis Gas* case the court said, at page 215:

> "We think the Commission cannot terminate a proceeding after it has actually conducted a hearing to the point of receiving an Examiner's initial decision, without rendering a decision upon the issue presented * * *. [W]e are of the

> opinion that the Commission, having received all the evidence the parties wish to present, and having before it an Examiner's findings, conclusion and decision, cannot at that point change its mind, wiping out the hearing as though it had never occurred, and in effect decide it will not enter upon a hearing."

In the present case, the examiner made a decision on the issue before him. The parties filed exceptions; the Commission listened to oral argument. These facts are identical to those in the *Minneapolis Gas* case. Moreover, in the instant proceeding and in *Minneapolis Gas*, the Commission terminated the cases without a decision on the issue presented—the justness and reasonableness of rates. In *Minneapolis Gas* the court found that the Commission had no discretion to terminate at this point; the court should have made the same judgment in the present case.

In the order denying rehearing the Commission said: "[W]e are given discretion as to whether to initiate proceedings either under Section 5(a) or 4(e) * * * Just as the statutes leave us with discretion as to whether to initiate proceedings we have authority to discontinue proceedings." (R. 396). Judge Fahy, following the *Minneapolis Gas* case, recognized the error of this position:

> "The Commission says it has a discretion to terminate as well as to initiate; but once it has exercised its discretion to initiate and has pursued the matter to the extent we find here its discretion to terminate is not as broad as was its discretion to initiate. The former becomes limited by the conditions existing at the time of its exercise." (R. 429).

Having initiated a proceeding under statutory direction and judicial mandate, and having pursued such course through extensive and exhaustive hearings and briefs to the point of an examiner's decision, exceptions and oral argument, the Commission is without discretion to inconclusively and indecisively terminate.

By so terminating without making the finding respecting the justness and reasonableness of the rates at issue, the Commission not only asserted unlawful discretion but also achieved the same

result which would have obtained had it made a finding of justness and reasonableness in Phillips' favor.

In *Louisville & Nashville R.R. v. Behlmer*, 175 U.S. 648 (1900) and *East T. V. & G. Ry. v. Interstate Commerce Commission*, 181 U.S. 1 (1901), this Court remanded rate cases to the Interstate Commerce Commission because that agency ruled in favor of certain parties before deciding the statutory issue of just and reasonable rates. The Court held that the parties were entitled as a matter of law to a decision on all the issues in the cases.

In *Greensboro-High Point Airport Authority v. Civil Aeronautics Board*, 231 F.2d 517 (D.C. Cir. 1956), the Airport Authority asserted in hearings before the agency that carriers serving the airport were discriminating against it in favor of another city. In a final order, the agency failed to decide that issue. The court held that the agency was required by law to decide the issues in the cases before it and remanded the matter to the agency, with directions to decide the issue and state the reasons for its decision.

The assertion of unlimited discretion to terminate proceedings is inconsistent with the Natural Gas Act which imposed upon the Commission the administrative duty of deciding rates in accordance with the standard of justness and reasonableness.

Moreover, Congress did not intend that the Commission's power to conduct extensive proceedings should be governed by an unlimited discretion whereby the Commission may terminate them at any time without reaching a conclusion. Whenever Congress sets up a regulatory agency it uniformly confers broad powers for investigation and for conduct of proceedings. These powers are not mere matters of discretion but essential parts of the regulatory process. See *Smith v. Interstate Commerce Commission*, 245 U.S. 33, 43-45 (1917); *Schaffer Transportation Co. v. United States*, 355 U.S. 83, 89 (1957).

Under the rationale of the *Minneapolis Gas* case, the Commission was required either to permit the examiner's decision to stand or to render its own decision. Its order of termination is erroneous as a matter of law.

C. THE PROCEEDING CANNOT BE LAWFULLY TERMINATED IN CONTRAVENTION OF THE JUDICIAL MANDATE TO FIX PHILLIPS' RATES.

When the Commission in 1948 instituted the Section 5(a) investigation of Phillips' rates it did so, among other reasons, for the purpose of determining whether the rates were just and reasonable. (R. 17-20). The Commission did not reach this determination because it found that it had no jurisdiction over Phillips. However, on appeal the Commission was reversed. "* * * Phillips is a 'natural-gas company' within the meaning of the Natural Gas Act and the Commission should *fix the rates at which these sales are made.*" *State of Wisconsin v. Federal Power Commission*, 205 F.2d 706, 712 (1954). (R. 405-406). (Emphasis supplied).

In apparent compliance with this mandate, which was affirmed by this Court, the Commission reopened the proceeding. (R. 407-409). The Commission did not assert that the reopening of the proceeding was a matter within its discretion. No such assertion was made until the order denying rehearing was issued. (R. 396).

California contends that the Commission neglected or refused to follow the clear instruction of the Court of Appeals "to fix the rates at which these sales are made." (R. 406). The Commission, therefore, acted contrary to the intention of this Court, the Court of Appeals, and the parties to the proceeding that the instant case would continue until the justness and reasonableness of Phillips' rates had been decided.

IV.

The Cost of Service Method of Regulation Must Not be Abandoned.

A. THE CONVENTIONAL COST OF SERVICE METHOD PROVIDES A LAWFUL, ESTABLISHED AND EFFECTIVE APPROACH FOR EVALUATING INDEPENDENT PRODUCER RATES.

One of the most important and far-reaching aspects of this proceeding was the rejection by the Commission and the court below of the conventional cost of service method of fixing just and reasonable rates for independent producers. The rejection is based on the contention that cost of service is unworkable and produces ridiculous results. (R. 414). The Commission supported

this conviction on the basis of experience, which it did not particularize, gained since this Court's *Phillips* decision in 1954. The court below, in turn, upheld the Commission on the ground that the agency should not be bound "by methods it now deems inadequate." (R. 421). A review of court and Commission decisions, during the period following the enactment of the Natural Gas Act, demonstrates that cost of service is, in fact, a lawful, established and effective method of determining just and reasonable rates, and for these reasons must not be abandoned.

1. Application of Cost of Service in the Regulation of Natural Gas Companies Prior to 1954.

Prior to this Court's *Phillips* decision in 1954, there were three decisions respecting the criteria for the regulation of natural gas companies. In *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U.S. 575 (1942), the question before this Court was whether the *Nebbia*[20] doctrine (that a state regulatory body may fix the prices charged by a business affected with a public interest so long as the price-fixing is reasonable, not arbitrary, and not capricious) could be applied to federal regulation under the Natural Gas Act. The Court held, at page 585, that the Commission could establish the "lowest reasonable rate" for a natural gas company and that this rate would not be confiscatory within the meaning of the Fifth Amendment. Moreover, the Court said, at page 586: "[T]he courts are without authority under the statute [Section 5(a)] to set aside as too low any 'reasonable rate' adopted by the Commission which is consistent with constitutional requirements." When the Court observed, at page 586, that the "Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas" the Court was only concerned with the constitutional requirement of due process. In other words, due process was not denied to the natural gas com-

20. *Nebbia v. New York*, 291 U.S. 502, 523-539 (1934).

party by the Commission's use of a particular formula in determining rate base."

In the *Natural Gas Pipeline* case this Court was not concerned with the non-constitutional problem of the limits of the Commission's statutory authority to apply rate making formulas. This is apparent from the following language found at page 586:

> "Agencies to whom this legislative power has been delegated are free, *within the ambit of their statutory authority*, to make pragmatic adjustments which may be called for by particular circumstances." (Emphasis supplied)

In the concurring opinion of Justices Black, Douglas and Murphy, it was pointed out, at page 600, that the "Commission has a broad area of discretion for selection of an appropriate rate base." The decision, then, does not authorize the Commission to use an approach other than the cost of service method but only indicates that the Commission may select what it considers the appropriate rate base under the circumstances. In all situations the Commission must stay within the ambit of its statutory authority.

The question of the scope of the Commission's statutory authority was raised in *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944). There the argument was raised that the Commission must set prices to discourage the industrial use of gas so that this wasting asset could be consumed for better purposes. The Court answered, at page 616:

> "Yet if we are now to tell the Commission to fix the rates so as to discourage particular uses, we would indeed be injecting into a rate case a *novel* doctrine which has no express statutory sanction." (Emphasis supplied)

Here this Court was pointing out that Congress authorized the Commission to determine rates in the traditional way and did not envision unusual procedures. Thus, the Court added: "Sec. 4(a) and Sec. 5(a) contain only conventional standards of rate making for natural-gas companies." Searching the legislative history of the Act, the Court further said, at page 616:

> "The Committee Report stated that the Act provided 'for regulation along recognized and more or less standardized lines' and that there was 'nothing novel in its provisions'."

It is beyond argument that the conventional, recognized and standardized means of regulation at the time the Natural Gas Act was passed was the cost of service method.

Several statements in the *Hope* case—"nor is it important to this case to determine the various permissible ways in which any rate base on which the return is computed might be arrived at" (page 603)—"The Commission was wholly justified in rejecting the latter [reproduction costs] as a measure of rate base" (page 605)—reveal that this Court also considered the cost of service approach to be the traditional method of regulation at the time of the Act, and to be the method by which Congress intended the Commission to regulate.

This consistent adherence to the cost of service approach by the Court is most strongly stated in *Colorado Interstate Gas Co. v. Federal Power Commission*, 324 U.S. 581, 602 (1945):

> "These provisions [several sections of the Act] all suggest that when Congress designed this Act it was thinking in terms of the ingredients of a rate base, the deductions which might be made, and the additions which were contemplated. * * * We must read Sec. 1(b) in the context of the whole Act. It must be reconciled with the explicit provisions which describe the normal conventions of rate-making."

In the 1954 decision in the *Phillips* case, this Court, recognizing the intent of Congress to regulate independent producers as natural gas companies, made no departure from the position that cost of service was the proper form of regulation under the Natural Gas Act. Consequently, the Commission's contention, in the instant proceeding, that it is not bound by the cost of service approach, is unsupported by law.

2. Application of Cost of Service in the Regulation of Natural Gas Companies Subsequent to 1954 and Prior to 1960.

In the period between this Court's *Phillips* decision and the Commission's opinion in the instant proceeding, the leading case concerning the Commission's application of rate making formulas was *City of Detroit, Michigan v. Federal Power Commission*, 230 F.2d 810 (D.C. Cir. 1955), cert. denied 352 U.S. 829 (1956). On review was a decision of the Commission which permitted Panhandle to recover in its rates the field price, or competitive price, for the gas produced by that pipeline company in its own fields, instead of a price based on the cost of producing the gas. *Panhandle Eastern Pipe Line Co.*, 13 FPC 53 (1954). In overruling the Commission the court held, at page 818, that conventional cost evidence must be used by the Commission at least as a basis of comparison. The court said:

> "It [cost of service] has been repeatedly used by the Commission, and repeatedly approved by the courts, as a means of arriving at lawful—'just and reasonable'—rates under the Act. Unless it is continued to be used at least as *a point of departure*, the whole experience under the Act is discarded and no anchor, as it were, is available by which to hold the terms 'just and reasonable' to some recognizable meaning." (Emphasis supplied).

After the *City of Detroit* case, the Commission itself also took this position. In *Union Oil Co. of California*, 16 FPC 100, 110 (1956), the Commission held that the *City of Detroit* case was controlling in independent producer rate cases.[21] In *Pan American Petroleum Corp.*, 19 FPC 519, 542-544 (1958), the Commission said that a producer could not show a rate to be just and reasonable absent evidence of cost of service. Commission demand for cost evidence was upheld in *Bel Oil Corp. v. Federal Power Commission*, 255 F.2d 548, 551-552 (5th Cir. 1958), cert. denied 358

21. Similar cases were: *Sun Oil Co.*, 17 FPC 174 (1956); *Orange Grove Oil & Gas Corp.*, 17 FPC 199 (1956); *H. F. Sears*, 18 FPC 214 (1957); *Delhi-Taylor Oil Corp.*, 18 FPC 375 (1957); *Sun Oil Co.*, 19 FPC 975 (1958).

U.S. 804 (1958); *Forest Oil Corp. v. Federal Power Commission*, 263 F.2d 622, 626 (5th Cir. 1959); *Episcopal Theological Seminary v. Federal Power Commission*, 269 F.2d 228, 236 (D.C. Cir. 1959), cert. denied 361 U.S. 895 (1959).

While during this period the Commission voiced its opposition to cost of service regulation of producers and supported legislation to free it from this method,[22] in those instances where it did act it followed that approach until the instant proceeding.

3. Application of Cost of Service in the Regulation of Natural Gas Companies Subsequent to 1960.

In the opinion in the instant proceeding the Commission made the following statement:

> "Experience of the Commission in this case, as well as in many other producer rate cases during the last five years, has shown, beyond any doubt, that the traditional original cost, prudent investment rate base method of regulating utilities is not a sensible, or even workable, method of fixing the rates of independent producers of natural gas. The fact that in this case, we can, by making numerous arbitrary allocations and estimates, arrive at a calculated unit cost of gas does not prove to anyone's satisfaction, including ours, that we have solved the problem of fixing prices for natural gas sold by independent producers. We recognize that the use of this method for regulating utilities provides only some possible aid toward solving, but not the answer to, the problem of fixing producers' rates." (R. 256-257).

This, of course, was directly contrary to the view of the examiner who stated that "the length and complexity of the instant *Phillips* proceeding cannot fairly be regarded as representative of the situation which will be commonly encountered in future rate proceedings * * *". (R. 65).

Because of this divergence of thought the position taken by the Commission and by its examiners subsequent to the present case is important. *Alfred C. Glassell, Jr.*, 25 FPC 1071 (1961), was the first independent producer rate case to follow the present case. The Commission said, at pages 1072-1073:

22. H.R. 6790, 85th Cong., 1st Sess. (1956).

"The examiner's reliance on cost of service evidence when he issued his decision on August 18, 1960, was correct. Since just and reasonable rates on an area basis have not yet been finally determined, for administrative reasons we have followed the practice of deciding on a cost of service basis proceedings which were ready for disposition on that basis prior to the announcement of our area price policy although we adhere to the view expressed in *Phillips* * * *. We will therefore make our decision on the same basis notwithstanding our comments in the *Phillips* opinion and Statement of General Policy No. 61-1."

Court review of the *Glassell* case was sought by the producer involved therein, *Alfred C. Glassell, Jr. v. Federal Power Commission*, United States Court of Appeals for the Fifth Circuit No. 19210. On February 8, 1962, the court remanded the case on the Commission's motion. In its motion the Commission stated:

"To some extent, at least, the Commission's experience has served to corroborate the view adopted in the present *Glassell* case that an abrupt abandonment of cost of service rate-making is not administratively feasible."

With one breath the Commission said cost of service is not sensible or workable; with the next breath it said it will use that very method in pending cases.

Commission examiners continue to rely on cost of service. In *Tidewater Oil Co.*, Docket No. G-13310, September 14, 1961, cost of service was applied and the examiner said: "[I]f the cost of service is constructed under the methods and techniques approved by the Commission * * * in the *Phillips* case, then the experience gained in the instant Tidewater proceeding would appear to demonstrate that the price results will be at a substantially lower level than field prices." (Mimeo. p. 5). In *Hunt Oil Co.*, Docket No. G-9065, October 2, 1961, and *Slade, Inc.*, Docket No. G-19986, November 1, 1961, examiners again used cost of service. The same was true in *Amerada Petroleum Corp.*, Docket No. G-9385, April 9, 1962. Here the examiner said:

> "Thus, insofar as independent producer cases in advance stages are concerned, the Commission not only by words but by deeds has receded from its view expressed in *Phillips* that the system-wide cost of service approach does not provide a workable basis for fixing rates for the future, at least until it concludes the area rate hearings which appears to be at a very considerable time in the future." (Mimeo. p. 12).

Finally, in a recent case, *Union Producing Co.*, Docket No. G-13811 June 26, 1962, the examiner adopted cost of service and pointed out:

> "[T]he Commission on numerous occasions has stated it did not intend to abandon the traditional cost-of-service method for determining rates for the future and especially in those cases which were in the hearing, or briefing, stage at the time the *Phillips* opinion was issued." (Mimeo. p. 15).

In the *Union Producing Co.* case, a consolidated Section 5(a) and Section 4(e) proceeding like the instant case, the examiner was able to provide sensible and workable solutions for problems involving depreciation and depletion, working capital, cost allocation, income taxes, and rate of return.

This history of producer rate cases subsequent to 1960 illustrates that cost of service is indeed a sensible and workable means of regulating producers. It is being utilized currently by the staff of the Commission as well as those producers who are parties to these various proceedings. There is no reason why the Commission should limit its use to cases pending prior to the opinion in the instant proceeding. The Commission should have used cost of service for the ultimate purpose of determining the justness and reasonableness of Phillips' rates, and should use it for this purpose in all such proceedings whether initiated before or after the issuance of the opinion here under review.

B. THE COMMISSION'S AND THE COURT'S OBJECTIONS TO COST OF SERVICE ARE UNSUPPORTED BY THE FACTS.

The court below, adopting the viewpoint of the Commission, listed several grounds for rejecting cost of service in producer rate

cases. The court asserted that such method "penalize[s] the efficient or fortunate and reward[s] the inefficient or unfortunate" (R. 414). Furthermore, "extremely difficult problems of allocating costs are involved." (R. 414). The Court referred to the royalty owners who may tend to lease to high cost producers only (R. 414-415). Finally, there is the "administrative burden of full rate cases for each of the thousands of independent producers." (R. 415). These grounds are without merit.

First, the court did not say how the so-called efficient or fortunate producer is penalized, what harm is inflicted upon him, how he suffers in contrast to the less efficient or unfortunate producer. The court's position assumes that there is some advantage to be gained by being inefficient and having bad luck. Under cost of service regulation both receive a fair return on investment and one is placed in no better position than the other. Actually, in our free enterprise system, other business factors, such as quality of service or competence of management, work to penalize the inept or unlucky and to favor the efficient or fortunate. Moreover, the court's position assumes that the producer with the high costs can sell his gas to pipelines at high rates in competition with the low cost producer, should such a competitive situation exist.

Second, the examiner's decision provides a sensible and workable formula for the allocation of costs between gas and oil. Neither the court nor the Commission questioned such formula. In pipeline rate cases the Commission often allocates with respect to the pipeline company's own production from joint product wells. Never has the Commission suggested that the cost of service method is unworkable in these situations because of the complexities of allocation.

Third, the rejection of cost of service in the interest of the royalty owners is unrealistic. The contention that these lease holders will lease to producers who can obtain high rates, thereby assuring greater royalties, is based on an ill-founded assumption that the lessor knows whether or not his lessee's operations will be efficient or fortunate, and knows the value of his land as a pro-

ducing field. To further assume that certain producers would intentionally increase costs or deliberately drill dry holes, for the benefit of royalty owners, is to sell short our free enterprise system as well as the natural gas industry.

Finally, the alleged administrative burden of producer rate cases can be met by an application of self-help and by the expedition of hearings and decisions. As already indicated, the delays incident to the instant proceeding—four years from the first hearing to the issuance of the opinion—and to the regulation of independent producers generally—twenty-four years from the enactment of the Act to the present—have been appalling. The mandate of Section 4(e) to "decide the same as speedily as possible" has not been followed. The blame for any administrative lag cannot be placed upon the cost of service method. One aid to overcoming any administrative burden would be to establish a uniform system of accounting and recording for producers. This the Commission has not done.

The foundation on which the rejection of cost of service is built is indeed very weak, if it exists at all. The cost of service computed by the Commission should have been applied to test Phillips' rates under the statutory standard. The reasons for not doing so in the instant proceeding, as well as for not applying it in future proceedings, are based on erroneous facts and unsupported assumptions.

C. THE NATURAL GAS ACT IS DESIGNED FOR COST OF SERVICE REGULATION.

The court below and the Commission, in abandoning cost of service, failed to consider the provisions of the Natural Gas Act as a single unit. When the Act is taken as a whole it becomes apparent that it was designed specifically by Congress to enable the Commission to regulate on a cost basis.

Section 6(a)[23] empowers the Commission to investigate and ascertain the actual legitimate cost of a natural gas company's

23. 52 Stat. 824 (1938), 15 U.S.C. § 717e(a) (1958). (Appendix A, p. 4).

property. Through Section 6(b)[24] the Commission may request an inventory of such property, a statement of its original cost, and information regarding the cost of additions to the property.

Section 8(a)[25] enables the Commission to prescribe the appropriate records to be kept and preserved, including records of cost-accounting procedures. Section 8(b)[26] provides that the Commission shall at all times have the right to inspect and examine all records of the natural gas company.

The Commission is given authority under Section 9[27] to require the carrying of proper and adequate depreciation and amortization accounts. Under Section 10[28] the Commission may demand annual and other periodic reports on such matters as "assets and liabilities, capitalization, investment and reduction thereof, gross receipts, interest due and paid, depreciation, amortization, and other reserves, cost of facilities, cost of maintenance and operation of facilities for the production, transportation or sale of natural gas, cost of renewal and replacement of such facilities, transportation, delivery, use, and sale of natural gas."

These provisions, together with Sections 4, 5 and 7, show a comprehensive plan of regulation based on cost and not a license for Commission action in an unlimited area.

All rates and charges made pursuant to the Natural Gas Act are dependent for lawfulness on an ultimate determination that said rates are just and reasonable. Just and reasonable rates must have their roots in a cost base. The Act has been so written to enable the Commission to obtain the financial and economic information necessary to use such method.

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24. 52 Stat. 824 (1938), 15 U.S.C. § 717e(b) (1958). (Appendix A, p. 4).

25. 52 Stat. 825 (1938), 15 U.S.C. § 717g(a) (1958). (Appendix A, p. 7).

26. 52 Stat. 825 (1938), 15 U.S.C. § 717g(b) (1958). (Appendix A, p. 8).

27. 52 Stat. 826 (1938), 15 U.S.C. § 717h (1958). (Appendix A, p. 8).

28. 52 Stat. 826 (1938), 15 U.S.C. § 717i (1958). (Appendix A, p. 9).

D. THE CONSTITUTIONAL RIGHTS OF PRODUCERS ARE PROTECTED BY COST OF SERVICE REGULATION.

California insists upon the continuation of regulation along cost lines because only this type of approach is in the public interest. Cost of service does not guarantee consumers the lowest possible rates; cost of service does assure rates which will protect consumers and which at the same time will assure the rights of the producers, as they must.

Congress has in Section 19(b) of the Natural Gas Act specifically cast upon the courts the duty to review rate orders of the Commission where any party is aggrieved. It is within the scope of the judicial power and part of judicial duty to restrain anything which, in the form of a regulation of rates, operates to deprive owners of their property without due process of law. *Chicago, M. & St. P. R. Co. v. Minnesota*, 134 U.S. 418, 455-456 (1890); *Federal Power Commission v. Natural Gas Pipe Line Co.*, 315 U.S. 575, 585, 609 (1942). A base of financial and economic information pertaining to the natural gas company is necessary to enable a court to determine whether or not a rate is confiscatory. The cost of service method provides this base.

California has had experience in regulation since 1911, together with regulatory experience gained in preceding years. It has been the experience of California that the only valid method of regulation is one which rests upon a foundation of cost. Absent costs, certainty is lost. As already indicated, California does not argue for cost of service because it assures consumers low prices. Consumers receive no such assurance. California favors cost of service because it is fair and equitable to industry and consumer alike. Regulation should not be based upon wispy concepts of value. Regulation must follow traditional lines and must be based upon certainties, such as, the company's debt money, equity capital, total wages, taxes, materials and supplies, and plant or rate base. Only through such course are consumers protected and producers guaranteed their rights.

E. A LOOK TO THE FUTURE.

It is beyond argument that the cost of service method is recognized as sensible and workable, and the lawfulness of such method has been determined by this and other courts. In short, it is an effective method of regulation. The gravity of the Commission's action in discarding cost of service must be measured against the realization that there is presently no known adequate or lawful substitute.

The Commission intends to explore the unknown for a theoretically ideal formula whereby producer rates and charges are precisely determined—but in the interim the only known and available weapon to be utilized for consumer protection has been laid down.

Assuming established commodity price levels for producer gas, should the Commission in the future have any doubt as to those prices, or to filings in conformity with such prices, what approach is the Commission going to use to test the lawfulness of the prices? If it is not the cost of service method which has been rejected, then it seems to California that the only remaining test would be some unknown, imprecise and arbitrary standard.

The abandonment of the cost approach is broad notice to all producers that any rate will be acceptable. An inability to prove an increase in his costs no longer dissuades a producer from filing for an increase, or consummating a sale at a high price. Area price levels are not a deterrent because a producer, under Section 4, has the right to file for increased rates at any time regardless of the pre-established levels. *H. L. Hunt v. Federal Power Commission*, United States Court of Appeals for the Fifth Circuit, No. 19065, July 19, 1962. A cost test then is the only safeguard for consumers.

Cost of service is as essential to future regulation as it was to past regulation. Its rejection in the instant proceeding brings uncertainty and confusion to the regulatory process.

V.

The Decision of the Court of Appeals and the Opinion of the Commission Fail to Provide Lawful Interim Regulation of Independent Producers.

"The difficult part of the case," said the court below, "* * * involves the rates for the period from 1959 until the new system—or a new system—is designed and established." (R. 421-422). This period includes all of Phillips' rates filed since January 1, 1959, whether they be increases under old contracts or initial prices in new contracts.

The difficulty lies in the type of regulation decided upon for this interim period which may last as long as fourteen years. (R. 422). The interim period extends from individual producer cost of service regulation, at one end, to the commodity pricing of gas on an area basis, at the other end. The form of regulation devised carries the Commission from the lawful, established and effective cost approach to the uncertain and untested area method. The vehicle offered to provide this transition is the Policy Statement.

A. THE POLICY STATEMENT IS FRAUGHT WITH LEGAL AND PRACTICAL INFIRMITIES WHICH MAKE IT AN UNLAWFUL AND INEFFECTIVE FORM OF REGULATION.

The court below approved the Commission's promulgation of the Policy Statement wherein the Commission established "maximum acceptable rates" above which it will suspend Section 4(e) rate increases and condition Section 7 initial price applications. (R. 344). Such levels, announced in conjunction with the instant proceeding (R. 325), are being used until new area rate procedures are developed, assuming they are developed. The court said:

> "[The Commission] has announced guideline rates which it deems to be on the basis of the internal data in its files on all operators in the several areas, fair rates for the product in those areas. *Such rates, thus determined, would seem to be just and reasonable rates for the consumers of the product.* And, similarly, they would seem to be just and reasonable charges for the producers to make." (R. 425). (Emphasis supplied).

What the court overlooked is that the rates contained in the Policy Statement were determined, and can be changed, without notice, hearing, or the taking of evidence. Moreover, the Commission itself does not consider the guideline rates to be necessarily just and reasonable rates:

> "These price levels, as announced by Appendix A attached to this statement, are for the purpose of guidance and initial action by the Commission and their use will not deprive any party of substantive rights, or fix the ultimate justness and reasonableness of any rate level." (R. 346).

California agrees with the Commission insofar as it stated that the Policy Statement rates are not just and reasonable by the fact of their promulgation. Of course, California disagrees with the court's characterization of them as "just and reasonable rates for consumers."

The question is whether or not the Policy Statement deprives parties of substantive rights. California contends that it does. Congress designed Sections 4(e) and 5(a) for the purpose of determining lawful rates under the just and reasonable standard. By the Policy Statement the Commission reserves the right to approve rate increases and initial prices on the sole criterion that they are at or below pre-established levels. These levels are admittedly not just and reasonable determinations. How then can the Commission base its rate making function, and its obligation to protect consumers, on these levels? Moreover, how is the Commission able to shift to other parties the burden of challenging rates which are at or below the Policy Statement levels?

An example of Commission performance under Policy Statement regulation is the case of *F. A. Callery, Inc.*, Docket No. G-13993. On November 27, 1957, F. A. Callery, Inc. (Callery) tendered for filing a proposed increase to 10.5¢ per Mcf in a sales contract with El Paso. The rate was suspended and, after expiration of the suspension period, became effective subject to refund. On December 23, 1960, the Commission consolidated this docket with other dockets in *Area Rate Proceeding, et al.*, Docket Nos. AR 61-1, et al. On May 16, 1962, the Commission issued an order terminating

the *Callery* proceeding and discharging Callery from any obligation to make refunds. 27 Fed. Reg. 4845 (1962). The reason offered by the Commission for the termination and discharge was that Callery's increased rate was below the applicable 11¢ per Mcf ceiling established by the Policy Statement. At no time did California, an intervenor, have an opportunity to assert a position as to the justness and reasonableness of the rate. Never was there a hearing or the taking of evidence respecting the rate. California, to protect its rights, petitioned for rehearing, which petition was granted on July 10, 1962, and further proceedings are pending.

Another example is *Shell Oil Co.*, Docket No. G-9446. This is a general rate investigation, pursuant to Section 5(a), of a major independent producer. Hearings commenced in this proceeding on July 7, 1960, and in the course of the hearings, California presented in evidence a cost of service showing. On August 1, 1962, the Commission severed those dockets of special interest to California from the *Shell* proceeding and consolidated them with *Area Rate Proceeding, et al.*, Docket Nos. AR 61-1, et al. Now, as a consequence of this action, California may have to wait as long as fourteen years for a decision as to the justness and reasonableness of Shell's rates, just as it has been required to wait for a decision in the instant proceeding.

These, of course, are examples of particular significance to California. However, they serve to emphasize the great power the Commission has conferred upon itself through this interim form of regulation.

The area price levels established in the Policy Statement were promulgated without notice to anyone. This was a failure to comply with Sections 4(a)[29] and 4(b)[30] of the Administrative Procedure Act which provide that notice of proposed rule making be published in the Federal Register and that the agency afford interested parties the opportunity to submit their views in writing.

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29. 60 Stat. 238 (1946), 5 U.S.C. § 1003(a) (1958). (Appendix A, p. 11).

30. 60 Stat. 238 (1946), 5 U.S.C. § 1003(b) (1958). (Appendix A, p. 11).

While Section 4(a) excepts statements of general policy from the notice requirement, the area price levels cannot be classified merely as policy matters since they are designed to have immediate effect and impact on rate making and rate lawfulness. Furthermore, by labeling the document a policy statement, interested persons were denied the right to petition, under Section 4(d)[31] of the Administrative Procedure Act, for amendment or repeal.

The Policy Statement levels are also unlawful because they were established without hearing and taking of evidence. Consumers have not been allowed to argue that the area levels are too high or that a particular producer should not be allowed a rate at the fixed level. The consumers' only recourse is a Section 5(a) proceeding, such as was abandoned in the instant proceeding; yet this does not provide adequate protection because of the absence of a provision for refunding excessive rates. Moreover, the Commission appears to have abandoned new company-wide Section 5(a) hearings pending decision, if such is forthcoming, on the area rate scheme.

Section 5[32] of the Administrative Procedure Act provides that where a statute calls for an agency hearing, there must be notice and opportunity to be heard. The Commission's own Rules of Practice and Procedure are especially designed for hearings on rate matters. FPC Rules and Regulations, Secs. 1.13-1.26, 18 C.F.R. §§ 1.13-1.26. Accordingly, the Commission's insistence on going its own way, without hearings, in rate matters is unprecedented.

If it be lawful for the Commission to announce rates as it did without notice and without hearing, and certainly without any evidence, then it is lawful for it to modify such rates in the future in like manner. Consequently, the Commission, unless prevented by this Court, can announce on any day a new policy statement and a new level of rates which might double, or triple, present

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31. 60 Stat. 238 (1946), 5 U.S.C. § 1003(d) (1958). (Appendix A, p. 12).

32. 60 Stat. 238 (1946), 5 U.S.C. § 1004 (1958). (Appendix A, p. 12).

prices. And the Commission, having abandoned cost of service, can justify its action on its own terms.

B. THE POLICY STATEMENT IS INCONSISTENT WITH THE FORM OF REGULATION PROVIDED BY THE NATURAL GAS ACT.

California insists that the pattern of regulation provided by the Natural Gas Act is the only lawful form of regulation and, moreover, such pattern provides for effective results. The innovations which are the consequence of the instant proceeding are not only unlawful but also constitute illusory regulation.

Section 4(e) provides that when a producer files for a rate increase the Commission shall have authority to enter upon a hearing "at once" concerning the lawfulness of such rate. Pending such hearing the Commission may suspend the increase for as long as five months. If the rate becomes effective before a hearing is concluded, the Commission may require a bond to assure refunds, if any are later ordered. The burden of proof that the increased rate is just and reasonable is placed upon the producer, and the "Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible."

Policy Statement regulation operates quite differently. By announcing maximum acceptable rates for increases under existing contracts, and by making the suspension and hearing provisions apply to rate increases above the acceptable levels, the Commission, in effect, established a rate floor. Rates that otherwise would be below the Policy Statement "ceiling" are in reality drawn up to that level as a floor.

While the ideal of a master rate for each gas producing area of the nation carries a certain appeal coming from notions of stability and permanency, nonetheless such a condition of static rates cannot in truth be achieved through the commodity price method, because Congress has made plain its intention as to the right of natural gas companies to file for increased rates under Section 4 of the Act. In *H. L. Hunt v. Federal Power Commission*,

United States Court of Appeals for the Fifth Circuit, No. 19065, July 19, 1962, the court said:

> "But we view the [Commission's] express prohibitions of § 4 increases as beyond the pale of administrative discretion. We do not think that under the guise of a condition of a temporary authorization, the Commission can forbid what Congress has expressly allowed to a natural gas producer." (Mimeo. p. 12)

In brief, producers will continue to file for rate increases as they have done in the past. All the Policy Statement accomplishes, then, is the raising of general area prices to a higher plateau.

Since the Natural Gas Act permits rates to be increased so easily, there must be some solid, meaningful measuring standard by which increased rates can be measured and quickly rejected, if found to be too high. If it be the objective of the Commission to curtail the upward increase in the price of natural gas, such increase, if improper, must be measured against a standard fixed under accepted criteria. Increases cannot be accepted, or rejected, by reference to other prices, so unstable and arbitrary as those set out in the Policy Statement. If it be the objective of the Commission to abate increasing producer prices, it can do so by comparing increases with rates and charges which were determined upon a basis of costs, for such rates will furnish an acceptable, reliable yardstick by which the Commission can lawfully evaluate rate increases.

Turning to the initial price levels in the Policy Statement, it is clear that, as regulatory controls, they are meaningless. Under the Policy Statement the Commission will issue a certificate of public convenience and necessity on the condition that the producer reduce the initial price to the applicable level. However, there is no way of preventing the producer from filing for a rate increase under the same contract on the next day, or the next minute. *H. L. Hunt v. Federal Power Commission*, United States Court of Appeals for the Fifth Circuit, No. 19065, July 19, 1962.

The plight of the consumers is especially aggravated by this situation respecting certificate proceedings under Section 7 of the

Act. All new projects, all new contracts, and all new sales by producers in interstate commerce are made under the authority of this section. Moreover, the continual growth of the natural gas industry means that there will be more and more applications for certificates. Consequently, consumers have a real interest in prices arranged by private contract and submitted to the Commission for approval. These initial prices are determined, and influenced, by the price levels set forth in the Policy Statement, which have never been scrutinized under the just and reasonable standard. (R. 346). Initial prices, instead of being held in line by the Commission, are brought up to the line drawn by the Policy Statement.

In the event the initial price or the established price levels are ultimately determined to be excessive in a Section 5 proceeding, such determination will be meaningless to consumers, who paid the untested prices, for the basic reason that there is no mechanism whereby the intervening overcharges may be recovered. This Court has already commented on this situation: "This long delay, without the protection of refund, as is possible in a § 4 proceeding, would provide a windfall for the natural gas company with a consequent squall for the consumers." *Atlantic Refining Co. v. Public Service Commission of the State of New York*, 360 U.S. 378, 390 (1959).

Under Policy Statement regulation, Section 5(a) rate proceedings, which permit no retroactive downward adjustments in rates through refunds, provide the only procedure whereby consumers, through state commissions, can demand that a hearing be held to determine whether initial prices in new contracts are just and reasonable and whether the Policy Statement levels are just and reasonable. A state commission may initiate such proceedings upon complaint. This Court, however, has commented upon "the delay incident to a determination in § 5 proceedings" referring to such as "nigh interminable." *Atlantic Refining Co. v. Public Service Commission of the State of New York*, 360 U.S. 378, 389 (1959).

Furthermore, a complaint, in reality, is a measure seldom used and, insofar as rates are concerned, not the statutory device intended by Congress for the protection of consumers. This Court

need only contemplate the difficulties facing the complainant who undertakes the massive effort to persuade the Commission that a producer's rates are unlawful. Unaided by the specialized staff of the Federal Power Commission and without the necessary familiarity with the Commission's records, maintained only in Washington, D. C., a Section 5 complainant is obviously in a difficult, if not impossible, position to bear the burden of a proper investigation. Thus, a Section 5 proceeding instituted by complaint is more of a notion than a reality.

California believes that there is no justification for this new form of regulation by Policy Statement fiat. Cost of service regulation under the Natural Gas Act is a lawful and effective way to regulate independent producers. It must be followed.

Six years after being ordered to commence regulation of producers, the Commission, upon the threshold of a lawful, established and effective manner of doing so, turns its back upon the process and sets forth into new, uncharted fields and courses. Judging by the Policy Statement, the answers it seeks, even if ultimately discerned, are certain to be fraught with legal and practical infirmities. Most importantly, the development of a new regulatory scheme apparently will require years of searching, exploration and experimentation which, when added to the time already expended by the Commission (now to be abruptly jetisoned), may produce at best a dubious method of regulation some fourteen years from now.

The opinion of the Commission and the decision of the court below in the instant proceeding have brought uncertainty and confusion to independent producer regulation by suspending statutory regulation while new theories are explored. Regulation has been replaced by experimentation. Consumer interests have been dispatched to a regulatory limbo to await a judgment that may never come.

VI.

The Spiral Escalation Clauses in Phillips' Contracts Are Derogatory of the Public Interest and Void in This Regulatory Setting.

Spiral escalation clauses can be explained by a description of their operation. These clauses permit increases in the contract price received by a producer from a pipeline company when there is an increase in a price index followed by an increase in the resale rates of the pipeline. When both these conditions are met, the contract price is increased in proportion to the increase in the resale rates. The Phillips-El Paso contracts contain typical spiral escalation clauses. These agreements provide that when the Bureau of Labor Statistics' Annual Index of Wholesale Prices of All Commodities increases more than a prescribed number of points and a general increase in El Paso's rates is put into effect, then Phillips' rates will be increased in proportion to the increase in El Paso's rates. (R. 201-203). (The spiral escalation clauses involved in this proceeding are set out in Appendix B to this Brief).

The spiral escalation clause, once it is activated, or triggered, results in an indefinite upward movement of the contract price. Under such a clause, rate increases obtained by the pipeline company cause an upward adjustment in the purchase contract price which, in turn, necessitates another rate increase for the pipeline company, leading to a new adjustment in the purchase contract price, and so on. The provision derives its distinctive name from this upward price spiraling effect.

Furthermore, Phillips has agreed to spiral escalation clauses in contracts with its suppliers. (R. 111-112). Consequently, when a pipeline company's resale rates are increased, thereby triggering Phillips into obtaining a Section 4(e) rate increase, Phillips is compelled to pay a correspondingly higher rate to its suppliers when they, in turn, increase their rates based on the spiral escalation clauses in their contracts with Phillips. The next step is only too apparent. Phillips, its gas purchase costs having increased, may demand higher prices for the gas it sells.

The unfortunate consequence of this multiple spiraling is the economic impact on the natural gas consumer. First, these in-

creases have no bearing on economic factors, such as the cost of producing gas, but are based on fortuitous events. Second, in California's instance, the price of natural gas to the California consumer is largely dependent upon the rates set by the Commission for the sale of gas by El Paso for resale in California. These rates, in turn, are dependent to a great extent upon the cost to El Paso of natural gas purchased by it from Phillips. Therefore, rate increases, resulting from the operation of spiral escalation clauses, are passed on to the ultimate consumer. It is the consumer's dollar, then, which permits Phillips the luxury of these devices.

Consumers of natural gas are caught in a maelstrom by such producer price mechanisms. As population increases more gas is required by the pipeline companies to render adequate service. If the pipeline companies buy new gas at higher prices, and obtain rate increases because of these higher costs, ironically, the escalator triggers are sprung which increase the price of all the gas they buy.

California insists that the nation is entitled to regulation which prohibits these contrived price adjustments.

In the instant proceeding, Section 4(e) Docket Nos. G-11217, G-10883, and G-10793 are rate increase filings based on the triggering of spiral escalation clauses. The Commission left open Docket Nos. G-11217 and G-10883 only for the resolution of the extent of the increase and for "no other matter." (R. 329). In the third docket, G-10793, the rate increase was allowed to become effective. Consequently, in each instance, the Commission gave legal effect to the clauses.

The Commission made it clear that one of the major issues in this proceeding was whether spiral escalation clauses are "so ambiguous in language and so inflationary in effect as to contravene the public interest and conflict with the regulatory powers of the Commission or are otherwise unlawful." (R. 32). Nevertheless, in its opinion, the Commission said:

> "While we do not approve of such clauses in principle, there is not sufficient basis on this record to hold them so derogatory of the public interest as to be void as a matter of law." (R. 327).

The Commission's failure to declare spiral escalation clauses void is one of the startling aspects of the opinion. It is especially surprising upon review of the Commission's position in *Michigan-Wisconsin Pipe Line Co.*, 13 FPC 326, 348-349 (1954). In that decision the Commission said:

> "Any provision in a gas purchase contract which provides for an increase based on the rates to be charged by the purchaser for the sale of such natural gas in interstate commerce for resale is *inconsistent with the standards of the Natural Gas Act and contrary to the public interest as a matter of law* * * *." (Emphasis supplied).

The strongest denunciation of spiral escalation clauses has been made by the Commission itself in *The Pure Oil Co.*, 25 FPC 383 (1961), affirmed *The Pure Oil Co., v. Federal Power Commission*, 299 F.2d 370 (1962). In that proceeding the Commission was considering whether indefinite escalation clauses were void or voidable. California believes it is rewarding to quote from that decision at length:

> "Considering all the circumstances, we are of the opinion that the two-party favored nation clauses in Pure's contracts with El Paso, and indefinite escalation clauses generally, are contrary to the public interest. From the beginning of Commission regulation of independent producers under the *Phillips* decision in 1954, the undesirable and injurious aspects of such escalation provisions generally have been forcibly impressed on us and proceedings were early instituted looking to the elimination of such provisions. And although the record in this case was made with special reference to Pure's two-party provisions, by reasonable implication it confirms our conclusion based upon our experience with other types of indefinite escalation provisions, that such provisions generally are contrary to the public interest. * * * (25 FPC at 388).
>
> "The record establishes that Pure's favored nation clauses are contrary to the public interest in a number of ways. First, they are, in the context of Commission regulation of producers under the Act, by their nature and in their effects inherently unreasonable. * * * In our view, such an artificial

ground for a proposed increase, operating in such a mechanical and arbitrary manner, and lacking any substantial relationship to the factors which bear on the value of gas or on a determination of a reasonable level of rates for it, does not constitute a proper basis for filing proposed increased rates or a sufficient justification for our giving effect to such a filing. * * * (25 FPC at 389).

"Assuming that indefinite escalation clauses in producer contracts had some justification years ago, when a lack of purchaser outlets and lack of consumer demand forced prices to abnormally low levels, this justification no longer exists today, when purchasers of gas are numerous, consumer demand is strong, and buyers are competing eagerly for available supplies of gas. In our judgment, in the light of continuing increases in the price of gas in recent years and the present high level of prices, escalation clauses such as Pure's have by now outlived whatever economic function they may have had * * *." (25 FPC at 391).

In conjunction with the issuance of the *Pure* decision, the Commission issued FPC Order No. 232, 26 Fed. Reg. 1983 (1961), and FPC Order No. 232A, 25 FPC 609 (1961), 26 Fed. Reg. 2850 (1961), wherein the Commission found that spiral escalation clauses were "undesirable, unnecessary, and incompatible with the public interest for the due and proper development of natural gas service by natural gas companies," and announced that contracts containing them, executed after April 3, 1961, would be rejected. Later, by FPC Order No. 242, 27 Fed. Reg. 1356 (1962), the Commission announced that contracts filed after April 2, 1962, would be unacceptable if they contained spiral escalation clauses. In this order the Commission said: "[I]n protecting the public against waves of increases which have no defensible basis, we also serve the need—which we believe we should take into account—of making the tasks of regulation more manageable."

In a recent case, a Commission examiner refused to allow rate increases based on indefinite escalation clauses, even though such clauses had been in contracts made prior to the above series of

orders. He said: "[The] clauses in Respondents' contracts are no longer consistent with the public interest, and therefore they must not be encouraged in a regulatory setting." *Shell Oil Co.*, Docket No. RI 61-515, July 24, 1962.

California's position is this: If spiral escalation clauses are contrary to the public interest they have always been so, regardless of the dates when the contracts were executed or filed.

Natural gas purchase contracts are long-term contracts, the usual duration being twenty years. Spiral escalation clauses in contracts executed prior to April 3, 1961, or filed prior to April 2, 1962, may well plague consumers for many years to come. They have no place, at any time, in the business practices of an industry which is affected with a public interest. Moreover, the Commission has no right, and certainly no discretion, to perpetuate the existence of something which is unlawful.

This proceeding presents the issue of whether or not spiral escalation clauses are valid on public policy grounds. It is a fundamental principle of law that courts will not lend their aid to uphold contracts which are inconsistent with public policy. *Marshall v. Baltimore & O. R. Co.*, 57 U.S. (16 How.) 314, 334 (1853); *Gibbs v. Consolidated Gas Co.*, 130 U.S. 396, 405-406 (1889); *Hazelton v. Sheckells*, 202 U.S. 71, 79 (1905); *Crocker v. United States*, 240 U.S. 74, 78-82 (1915); *United States v. Mississippi Valley Generating Co.*, 364 U.S. 520, 564-566 (1961).

In *South Carolina Generating Co.*, 19 FPC 855, 860-862 (1958), the Commission found that an automatic escalation clause in an electric energy purchase contract was unjust and unreasonable. This finding was sustained on appeal. *South Carolina Generating Co., v. Federal Power Commission*, 261 F.2d 915, 917 (4th Cir. 1958). A similar finding should have been made in the instant proceeding.

It is significant that spiral escalation clauses were included in Phillips' contracts before Phillips was held to be within the Commission's jurisdiction. Their origin at a time when the regulation of producers was unknown makes such provisions all the more questionable. That these clauses are the result of private

agreement does not entitle them to any special consideration in a regulatory setting. As one court has stated: "That private contract rights must yield to the public welfare, where the latter is appropriately declared and defined and the two conflict, has often been decided by this Court." *Mississippi River Fuel Corp. v. Federal Power Commission*, 121 F.2d 159, 163 (8th Cir. 1941).

The court below recognized the unlawful character of these devices, but erred in holding the question of their legality not ripe for review. The court said:

> "Wisconsin and California contend that the Commission should now declare these escalation clauses to be illegal and void as against public policy. As a matter of fact the Commission has declared these clauses to be against the public interest and that they should be held inoperative. But, the Commission says, insofar as these cases of Phillips are concerned, action of the sort demanded by Wisconsin and California is premature. Action on these clauses, it says, should await action on the pending cases which in orderly processes present the problem for decision. We agree with the Commission." (R. 426-427).

The court neglected to note that Dockets Nos. G-11217 and G-10883 were left open only to await the outcome of the pipeline companies' rate proceedings so that the Commission might determine the amounts of price escalation Phillips would receive under the clauses. The escalation clause in Docket No. G-10793, being unaffected by pending pipeline company litigation, was approved outright. In each instance, Commission approval of the spiral escalation clauses themselves presents the issue for review. See *Atlantic Seaboard Corp. v. Federal Power Commission*, 204 F.2d 568, 572 (4th Cir. 1953).

Spiral escalation clauses, the cause of consumer price increases which are unrelated to the factors involved in procuring gas, and the product of contract negotiations which were unrestrained by any regulatory influence, permit the exploitation of consumers in contravention of the primary purpose of the Natural Gas Act. Such contract provisions are derogatory of the public interest and void in this regulatory setting.

VII.

The National Importance and Significance of Independent Producer Regulation.

Independent producers, such as Phillips, sell natural gas to pipeline companies, such as El Paso, at wellheads, at field gathering points, or at outlets of processing plants. The prices established at these points of sale are crucial in the determination of the prices set by the pipeline companies in their sales to the distributing companies, and the prices charged by the latter to the ultimate consumers of the nation.

Absent producer regulation, the Natural Gas Act would be only a makeshift barricade against a surging river without any attempt to control the river itself. It should now be apparent to all that the regulation of pipeline prices was less than whole when the prices paid by the pipelines to the producers were unregulated.

Effective regulation of independent producers is possible under the Act as written by Congress. But proceedings must be handled with zeal and dispatch, and not with indecision, indifference and delay.

The need for effective producer regulation is emphasized by the rising cost of producer gas.

In 1950 producer sales, nation-wide, amounted to $409,000,000. By 1960, as the amount of gas sold doubled, the dollar cost of producers' gas increased over four times to $1,790,000,000.[33] When these staggering figures are translated into the cost to the ultimate gas consumers, they are further increased because of the expenses of and the return to pipelines and local distributing companies.

Time is crucial in this proceeding. Accordingly, the proceeding may best be disposed of, in the national interest, by following the position of Judge Fahy in his dissent:

> "These cases need not be treated as if they were ventures initiated in search of an ideal method of regulating the rates of independent gas producers. Having in mind the history of these proceedings, and the primary congressional purpose

33. Source: Bureau of Mines Mineral Yearbook, U.S. Dept. of Interior, Vols. 1951 and 1960.

> of consumer protection, it seems to me that decisions on the present record, supplemented as may be found to be reasonably necessary, would be far more likely to approximate fulfillment of the purposes of the Act than are the termination order and the resulting situation." (R. 429).

The consumers, at the extreme end of the pipeline, can have no effective regulatory protection unless the rates at which the producers sell their gas to the pipelines are adequately regulated. This Court, in referring to the sale of gas in the field to a pipeline company, has said:

> "Unreasonable charges extracted at this stage of the interstate movement become perpetuated in large part in fixed items of costs which must be covered by rates charged subsequent purchasers of gas, including the ultimate consumer." *Interstate Natural Gas Co. v. Federal Power Commission*, 331 U.S. 682, 693 (1947).

Effective regulation requires that there be no gap in the regulatory scheme at either the production or the consumer end of the pipeline.

CONCLUSION

California has a vital interest in all matters concerned with the regulation of natural gas companies. This interest arises from the fact that California gas distributing utilities, serving a population in excess of fifteen million people, are dependent upon out-of-state supplies for over three-quarters of the natural gas consumed within the State.

The Commission's action in terminating this proceeding, without a determination on the issue of the lawfulness of Phillips' rates, deprived California of its right to a decision and the public of its interest in the enforcement of the Natural Gas Act in accordance with the dictates of Congress.

By way of relief, California requests:

1. That the decision of the Court of Appeals be reversed, and the Commission's order of termination be set aside.

2. That the proceeding be remanded to the Commission with directions to take whatever action is necessary to correct the errors specified herein.

3. Such other relief as to this Court may seem meet and proper.

Respectfully submitted,

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Dated: August 22, 1962.

(Appendices Follow)

Appendix A

RELEVANT PARTS OF STATUTES INVOLVED

The relevant parts of the Natural Gas Act (Act of June 21, 1938, c. 556, 52 Stat. 821-833 (1938), 15 U.S.C. §§ 717-717w (1958)) involved in this proceeding are as follows:

SEC. 1. (a) As disclosed in reports of the Federal Trade Commission made pursuant to Senate Resolution 83 (Seventieth Congress, first session) and other reports made pursuant to the authority of Congress, it is hereby declared that the business of transporting and selling natural gas for ultimate distribution to the public is affected with a public interest, and that Federal regulation in matters relating to the transportation of natural gas and the sale thereof in interstate and foreign commerce is necessary in the public interest.

SEC. 4. (a) All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.

(b) No natural-gas company shall, with respect to any transportation or sale of natural gas subject to the jurisdiction of the Commission, (1) make or grant any undue preference or advantage to any person or subject any person to any undue prejudice or disadvantage, or (2) maintain any unreasonable difference in rates, charges, service, facilities, or in any other respect, either as between localities or as between classes of service.

(c) Under such rules and regulations as the Commission may prescribe, every natural-gas company shall file with the Commission, within such time (not less than sixty days from the date this act takes effect) and in such form as the Commission may designate, and shall keep open in convenient form and place for public inspection, schedules showing all rates and charges for any trans-

poration or sale subject to the jurisdiction of the Commission, and the classifications, practices, and regulations affecting such rates and charges, together with all contracts which in any manner affect or relate to such rates, charges, classifications, and services.

(d) Unless the Commission otherwise orders, no change shall be made by any natural-gas company in any such rate, charge, classification, or service, or in any rule, regulations, or contract relating thereto, except after thirty days' notice to the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. The Commission, for good cause shown, may allow changes to take effect without requiring the thirty days' notice herein provided for by an order specifying the changes so to be made and the time when they shall take effect and the manner in which they shall be filed and published.

(e) Whenever any such new schedule is filed the Commission shall have authority, either upon complaint of any State, municipality, or State commission, or upon its own initiative without complaint, at once, and if it so orders, without answer or formal pleading by the natural-gas company, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the natural-gas company affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect: *Provided*, That the Commission shall not have authority to suspend the rate, charge, classification, or service for the sale of natural gas for resale for industrial use only; and after full hearings, either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper

in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made at the expiration of the suspension period, on motion of the natural-gas company making the filing, the proposed change of rate, charge, classification, or service shall go into effect. Where increased rates or charges are thus made effective, the Commission may, by order, require the natural-gas company to furnish a bond, to be approved by the Commission, to refund any amounts ordered by the Commission, to keep accurate accounts in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts were paid, and, upon completion of the hearing and decision, to order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the natural-gas company, and the Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible.

SEC. 5. (a) Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: *Provided, however*, That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural-gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such

natural-gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates.

(b) The Commission upon its own motion, or upon the request of any State commission, whenever it can do so without prejudice to the efficient and proper conduct of its affairs, may investigate and determine the cost of the production or transportation of natural gas by a natural-gas company in cases where the Commission has no authority to establish a rate governing the transportation or sale of such natural gas.

SEC. 6. (a) The Commission may investigate and ascertain the actual legitimate cost of the property of every natural-gas company, the depreciation therein, and, when found necessary for rate-making purposes, other facts which bear on the determination of such cost or depreciation and the fair value of such property.

(b) Every natural-gas company upon request shall file with the Commission an inventory of all or any part of its property and a statement of the original cost thereof, and shall keep the Commission informed regarding the cost of all additions, betterments, extensions, and new construction.

SEC. 7. (a) Whenever the Commission, after notice and opportunity for hearing, finds such action necessary or desirable in the public interest, it may by order direct a natural-gas company to extend or improve its transportation facilities, to establish physical connection of its transportation facilities with the facilities of, and sell natural gas to, any person or municipality engaged or legally authorized to engage in the local distribution of natural or artificial gas to the public, and for such purpose to extend its transportation facilities to communities immediately adjacent to such facilities or to territory served by such natural-gas company, if the Commission finds that no undue burden will be placed upon such natural-gas company thereby: *Provided*, That the Commission shall have no authority to compel the enlargement of transportation facilities for such purposes, or to compel such natural-gas company to establish physical connection or sell

natural gas when to do so would impair its ability to render adequate service to its customers.

(b) No natural-gas company shall abandon all or any portion of its facilities subject to the jurisdiction of the Commission, or any service rendered by means of such facilities, without the permission and approval of the Commission first had and obtained, after due hearing, and a finding by the Commission that the available supply of natural gas is depleted to the extent that the continuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment.

(c) No natural-gas company or person which will be a natural-gas company upon completion of any proposed construction or extension shall engage in the transportation or sale of natural gas, subject to the jurisdiction of the Commission, or undertake the construction or extension of any facilities therefor, or acquire or operate any such facilities or extensions thereof, unless there is in force with respect to such natural-gas company a certificate of public convenience and necessity issued by the Commission authorizing such acts or operations: *Provided, however*, That if any such natural-gas company or predecessor in interest was bona fide engaged in transportation or sale of natural gas, subject to the jurisdiction of the Commission, on the effective date of this amendatory Act, over the route or routes or within the area for which application is made and has so operated since that time, the Commission shall issue such certificate without requiring further proof that public convenience and necessity will be served by such operation, and without further proceedings, if application for such certificate is made to the Commission within ninety days after the effective date of this amendatory Act. Pending the determination of any such application, the continuance of such operation shall be lawful.

In all other cases the Commission shall set the matter for hearing and shall give such reasonable notice of the hearing thereon to all interested persons as in its judgment may be necessary under rules and regulations to be prescribed by the Commission, and the application shall be decided in accordance with the pro-

cedure provided in subsection (e) of this section and such certificate shall be issued or denied accordingly: *Provided, however,* That the Commission may issue a temporary certificate in cases of emergency, to assure maintenance of adequate service or to serve particular customers, without notice or hearing, pending the determination of an application for a certificate, and may by regulation exempt from the requirements of this section temporary acts or operations for which the issuance of a certificate will not be required in the public interest.

(d) Application for certificate shall be made in writing to the Commission, be verified under oath, and shall be in such form, contain such information, and notice thereof shall be served upon such interested parties and in such manner as the Commission shall, by regulation, require.

(e) Except in the cases governed by the provisos contained in subsection (c) of this section, a certificate shall be issued to any qualified applicant therefor, authorizing the whole or any part of the operation, sale, service, construction, extension, or acquisition covered by the application, if it is found that the applicant is able and willing properly to do the acts and to perform the service proposed and to conform to the provisions of the Act and the requirements, rules, and regulations of the Commission thereunder, and that the proposed service, sale, operation, construction, extension, or acquisition, to the extent authorized by the certificate, is or will be required by the present or future public convenience and necessity; otherwise such application shall be denied. The Commission shall have the power to attach to the issuance of the certificate and to the exercise of the rights granted thereunder such reasonable terms and conditions as the public convenience and necessity may require.

(f) The Commission, after a hearing had upon its own motion or upon application, may determine the service area to which each authorization under this section is to be limited. Within such service area as determined by the Commission a natural-gas company may enlarge or extend its facilities for the purpose of supplying increased market demands in such service area without further authorization.

(g) Nothing contained in this section shall be construed as a limitation upon the power of the Commission to grant certificates of public convenience and necessity for service of an area already being served by another natural-gas company.

(h) When any holder of a certificate of public convenience and necessity cannot acquire by contract, or is unable to agree with the owner of property to the compensation to be paid for, the necessary right-of-way to construct, operate, and maintain a pipe line or pipe lines for the transportation of natural gas, and the necessary land or other property, in addition to right-of-way, for the location of compressor stations, pressure apparatus, or other stations or equipment necessary to the proper operation of such pipe line or pipe lines, it may acquire the same by the exercise of the right of eminent domain in the district court of the United States for the district in which such property may be located, or in the State courts. The practice and procedure in any action or proceeding for that purpose in the district court of the United States shall conform as nearly as may be with the practice and procedure in similar action or proceeding in the courts of the State where the property is situated: *Provided*, That the United States district courts shall only have jurisdiction of cases when the amount claimed by the owner of the property to be condemned exceeds $3,000.

SEC. 8. (a) Every natural-gas company shall make, keep, and preserve for such periods, such accounts, records of cost-accounting procedures, correspondence, memoranda, papers, books, and other records as the Commission may by rules and regulations prescribe as necessary or appropriate for purposes of the administration of this act: *Provided, however*, That nothing in this act shall relieve any such natural-gas company from keeping any accounts, memoranda, or records which such natural-gas company may be required to keep by or under authority of the laws of any State. The Commission may prescribe a system of accounts to be kept by such natural-gas companies, and may classify such natural-gas companies and prescribe a system of accounts for each class. The Commission, after notice and opportunity for hearing, may de-

termine by order the accounts in which particular outlays or receipts shall be entered, charged, or credited. The burden of proof to justify every accounting entry questioned by the Commission shall be on the person making, authorizing, or requiring such entry, and the Commission may suspend a charge or credit pending submission of satisfactory proof in support thereof.

(b) The Commission shall at all times have access to and the right to inspect and examine all accounts, records, and memoranda of natural-gas companies; and it shall be the duty of such natural-gas companies to furnish to the Commission, within such reasonable time as the Commission may order, any information with respect thereto which the Commission may by order require, including copies of maps, contracts, reports of engineers, and other data, records, and papers, and to grant to all agents of the Commission free access to its property and its accounts, records, and memoranda when requested so to do. No member, officer, or employee of the Commission shall divulge any fact or information which may come to his knowledge during the course of examination of books, records, data, or accounts, except insofar as he may be directed by the Commission or by a court.

SEC. 9. (a) The Commission may, after hearing, require natural-gas companies to carry proper and adequate depreciation and amortization accounts in accordance with such rules, regulations, and forms of account as the Commission may prescribe. The Commission may from time to time ascertain and determine, and by order fix, the proper and adequate rates of depreciation and amortization of the several classes of property of each natural-gas company used or useful in the production, transportation, or sale of natural gas. Each natural-gas company shall conform its depreciation and amortization accounts to the rates so ascertained, determined, and fixed. No natural-gas company subject to the jurisdiction of the Commission shall charge to operating expenses any depreciation or amortization charges on classes of property other than those prescribed by the Commission, or charge with respect to any class of property a percentage of depreciation or amortization other than that prescribed therefor by the Com-

mission. No such natural-gas company shall in any case include in any form under its operating or other expenses any depreciation, amortization, or other charge or expenditure included elsewhere as a depreciation or amortization charge or otherwise under its operating or other expenses. Nothing in this section shall limit the power of a State commission to determine in the exercise of its jurisdiction, with respect to any natural-gas company, the percentage rates of depreciation or amortization to be allowed, as to any class of property of such natural-gas company, or the composite depreciation or amortization rate, for the purpose of determining rates or charges.

(b) The Commission, before prescribing any rules or requirements as to accounts, records, or memoranda, or as to depreciation or amortization rates, shall notify each State commission having jurisdiction with respect to any natural-gas company involved and shall give reasonable opportunity to each such commission to present its views and shall receive and consider such views and recommendations.

SEC. 10. (a) Every natural-gas company shall file with the Commission such annual and other periodic or special reports as the Commission may by rules and regulations or order prescribe as necessary or appropriate to assist the Commission in the proper administration of this act. The Commission may prescribe the manner and form in which such reports shall be made, and require from such natural-gas companies specific answers to all questions upon which the Commission may need information. The Commission may require that such reports shall include, among other things, full information as to assets and liabilities, capitalization, investment and reduction thereof, gross receipts, interest due and paid, depreciation, amortization, and other reserves, cost of facilities, cost of maintenance and operation of facilities for the production, transportation, or sale of natural gas, cost of renewal and replacement of such facilities, transportation, delivery, use, and sale of natural gas. The Commission may require any such natural-gas company to make adequate provision

for currently determining such costs and other facts. Such reports shall be made under oath unless the Commission otherwise specifies.

(b) It shall be unlawful for any natural gas company willfully to hinder, delay, or obstruct the making, filing, or keeping of any information, document, report, memorandum, record, or account required to be made, filed, or kept under this act or any rule, regulation, or order thereunder.

SEC. 19. (b) Any party to a proceeding under this act aggrieved by an order issued by the Commission in such proceeding may obtain a review of such order in the circuit court of appeals of the United States for any circuit wherein the natural-gas company to which the order relates is located or has its principal place of business, or in the United States Court of Appeals for the District of Columbia, by filing in such court, within sixty days after the order of the Commission upon the application for rehearing, a written petition praying that the order of the Commission be modified or set aside in whole or in part. A copy of such petition shall forthwith be transmitted by the clerk of the court to any member of the Commission and thereupon the Commission shall file with the court the record upon which the order complained of was entered, as provided in section 2112 of title 28, United States Code. Upon the filing of such petition such court shall have jurisdiction, which upon the filing of the record with it shall be exclusive, to affirm, modify, or set aside such order in whole or in part. No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission in the application for rehearing unless there is reasonable ground for failure so to do. The finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. If any party shall apply to the court for leave to adduce additional evidence, and shall show to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence in the proceedings before the Commission, the court may order such additional evidence to be taken before the Commission

and to be adduced upon the hearing in such manner and upon such terms and conditions as to the court may seem proper. The Commission may modify its findings as to the facts by reason of the additional evidence so taken, and it shall file with the court such modified or new findings, which if supported by substantial evidence, shall be conclusive, and its recommendation, if any, for the modification or setting aside of the original order. The judgment and decree of the court, affirming, modifying, or setting aside, in whole or in part, any such order of the Commission, shall be final, subject to review by the Supreme Court of the United States upon certiorari or certification as provided in [former] sections 239 and 240 of the Judicial Code, as amended (U.S.C., title 28, sec. 1254).

The Relevant Parts of the Administrative Procedure Act (Act of June 11, 1946, c. 324, 60 Stat. 242-244 (1946), 5 U.S.C. §§ 1001-1011 (1958)), involved in this proceeding are:

Sec. 4(a). General notice of proposed rule making shall be published in the Federal Register (unless all persons subject thereto are named and either personally served or otherwise have actual notice thereof in accordance with law) and shall include (1) a statement of the time, place, and nature of public rule making proceedings; (2) reference to the authority under which the rule is proposed; and (3) either the terms or substance of the proposed rule or a description of the subjects and issues involved. Except where notice or hearing is required by statute, this subsection shall not apply to interpretative rules, general statements of policy, rules of agency organization, procedure, or practice, or in any situation in which the agency for good cause finds (and incorporates the finding and a brief statement of the reasons therefor in the rules issued) that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest.

Sec. 4(b). After notice required by this section, the agency shall afford interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments with or without opportunity to present the same orally in

any manner; and, after consideration of all relevant matter presented, the agency shall incorporate in any rules adopted a concise general statement of their basis and purpose. Where rules are required by statute to be made on the record after opportunity for an agency hearing, the requirements of sections 7 and 8 shall apply in place of the provisions of this subsection.

Sec. 4(d). Every agency shall accord any interested person the right to petition for the issuance, amendment, or repeal of a rule.

Sec. 5. In every case of adjudication required by statute to be determined on the record after opportunity for an agency hearing, except to the extent that there is involved (1) any matter subject to a subsequent trial of the law and the facts de novo in any court; (2) the selection or tenure of an officer or employee of the United States other than examiners appointed pursuant to section 1010 of this title; (3) proceedings in which decisions rest solely on inspections, tests, or elections; (4) the conduct of military, naval, or foreign affairs functions; (5) cases in which an agency is acting as an agent for a court; and (6) the certification of employee representatives.

* * * * * * *

(b) The agency shall afford all interested parties opportunity for (1) the submission and consideration of facts, arguments, offers of settlement, or proposals of adjustment where time, the nature of the proceeding, and the public interest permit, and (2) to the extent that the parties are unable so to determine any controversy by consent, hearing, and decision upon notice and in conformity with sections 7 and 8 of this title.

Sec. 8(b). Prior to each recommended, initial, or tentative decision, or decision upon agency review of the decision of subordinate officers the parties shall be afforded a reasonable opportunity to submit for the consideration of the officers participating in such decisions (1) proposed findings and conclusions, or (2) exceptions to the decisions or recommended decisions of subordinate officers or to tentative agency decisions, and (3) sup-

porting reasons for such exceptions or proposed findings or conclusions. The record shall show the ruling upon each such finding, conclusion, or exception presented. All decisions (including initial, recommended, or tentative decisions) shall become part of the record and include a statement of (1) findings and conclusions, as well as the reasons or basis therefor, upon all the material issues of fact, law, or discretion presented on the record; and (2) the appropriate rule, order, sanction, relief, or denial thereof.

Appendix B

SPIRAL ESCALATION CLAUSES CONTAINED IN CONTRACTS OF PHILLIPS PETROLEUM COMPANY

The following is the spiral escalation clause found in the contract agreement between Phillips and El Paso Natural Gas Company, dated January 1, 1953, FPC Rate Schedule No. 7:

In order to protect the parties hereto from too great burden under the price provisions of this agreement in the event of abnormal inflation or deflation of prices of commodities generally, it is agreed that in the event of the happening of the contingencies hereinafter mentioned, an adjustment of the prices to be paid by El Paso to Phillips for gas hereunder shall be made as herein provided. Using as a standard the Federal Bureau of Labor Statistics' Annual Index of Wholesale Prices of All Commodities for any calendar year, based upon or adjusted to 1947-1949 prices as one hundred (100) and defining the word "point" as used herein to mean one percent (1%) of the 1947-1949 prices, it is agreed that no adjustment shall be made unless and until (1) the Annual Index shall be more than nineteen point naught six (19.06) points above the level seventy-six point nine (76.9) and El Paso shall have had an increase in resale rates, or (2) the Annual Index shall be more than nineteen point naught six (19.06) points below the level seventy-six point nine (76.9) and El Paso shall have had a decrease in resale rates. When revised rates shall become effective during any adjustment period, the price for gas delivered hereunder shall be adjusted to a price which bears the same ratio to the price provided in Section 1 of this Article which the revised resale rates bear to the resale rates in effect immediately prior to revision. The ratio referred to above shall be determined by applying the revised resale rates and the resale rates in effect immediately prior to revision respectively to the total volumes of gas sold by El Paso for resale during the twelve (12) calendar months next preceding said determination in the same manner as if such rates

respectively had been in effect. Further proportionate adjustments in the prices hereunder shall be made in the same manner whenever a further increase or decrease in the rates of El Paso shall become effective during any adjustment period; provided, that whenever the Annual Index shall be not more than nineteen point naught six (19.06) points above or below seventy-six point nine (76.9), the prices provided in Section 1 of this Article shall again be in effect. Whenever the Annual Index shall be more than nineteen point naught six (19.06) points above seventy-six point nine (76.9), El Paso shall diligently pursue all rights and remedies to which it is entitled in a good faith endeavor to bring about, and procure the approval of, an increase or succesive increases, as the case may be, in its rates to bring its rates up to the inflated price level. El Paso shall notify Phillips in writing within ten (10) days after receipt by El Paso of any general increase or decrease during any adjustment period in rates for gas sold by it for resale. The term "adjustment period" as used in this Section means the period beginning on the first day of the calendar month following the publication of the Annual Index showing such Index to be more than nineteen point naught six (19.06) points above or below seventy-six point nine (76.9) and ending on the first day of the calendar month following the publication of the Annual Index showing such Index to be less than nineteen point naught six (19.06) points above or below seventy-six point nine (76.9). For the purpose of applying the provisions of this Section, the price for gas delivered hereunder as provided in Section 1 of this Article shall be deemed to be the price provided in said Section 1, exclusive of the provisions relating to the weighted average price of gas at gasoline plants in the Permian Basin Area, and exclusive of the provisions of this Article relating to higher prices paid to others. If, for any calendar year an Annual Index is not published on or before April 1 of the following year, the Annual Index shall be deemed to be the arithmetic average of the monthly indices for the twelve (12) months of such calendar year and shall be deemed to have been published in March.

It is understood that the figure seventy-six point nine (76.9) used in this Section 4 refers to a certain level of the Wholesale Price Index Number for "all commodities" as heretofore determined by the Bureau of Labor Statistics of the United States Department of Labor based upon the 1947-1949 level of prices as one hundred (100). If the said Bureau (or a successor governmental agency) shall discontinue the publication of said Index for "all commodities" based on such 1947-1949 level, and shall adopt as a base price a level other than that of 1947-1949, the said figure seventy-six point nine (76.9) shall be adjusted accordingly. In the event publication of the Wholesale Price Index for "all commodities" shall be discontinued, the parties shall mutually agree upon the substitution of some other means of establishing an index number.

The following is the spiral escalation clause found in the contract agreement between Phillips and Panhandle Eastern Pipe Line Company, dated April 5, 1943, FPC Gas Rate Schedule No. 5:

In order to protect the parties hereto from too great a burden under the provisions of this contract in the event of abnormal inflation or deflation of prices of commodities generally, it is agreed that in the event of the contingencies hereinafter mentioned, an adjustment of the prices to be paid by Panhandle Eastern to Phillips for gas hereunder shall be made as herein provided. Using as a standard the Federal Bureau of Labor's Statistical Annual Index of Wholesale Prices of All Commodities, based upon 1947-1949 prices as 100% and defining the word 'point' as used herein to mean 1% of the 1947-1949 prices, it is agreed that no adjustment shall be made unless and until the said Annual Index shall be more than nineteen point naught six (19.06) above or below sixty-five point nine (65.9) and unless and until Panhandle shall have had a general increase or decrease in rates for gas from its pipe line system. However, if, when the said Annual Index is more than nineteen point naught six (19.06) above sixty-five point nine (65.9) the Federal Power Commission or other body or court having jurisdiction, shall grant to Pan-

handle Eastern a general increase in its rates for gas sold from its pipe line, it shall be conclusively presumed that such increase is due to inflation and the prices for gas hereunder shall be increased in proportion to such increase in Panhandle Eastern's rates; and if, when the said Annual Index is more than nineteen point naught six (19.06) below sixty-five point nine (65.9), said commission, or other body or court, shall require a general decrease in Panhandle Eastern's rates for gas sold from its pipe line system, it shall be conclusively presumed that such decrease is due to deflation and the prices for gas hereunder shall be reduced in proportion to such decrease in Panhandle Eastern's rates. Further proportionate adjustments in the prices hereunder shall be made in the same manner whenever a general increase or decrease in Panhandle Eastern's rates shall be put into effect; provided, that whenever the said Annual Index shall be not more than nineteen point naught six (19.06) above or below sixty-five point nine (65.9), the prices hereinabove specified shall again be in effect without adjustment.

The following is the spiral escalation clause found in the contract agreement between Phillips and Michigan-Wisconsin Pipe Line Company, dated December 11, 1945, FPC Gas Rate Schedule No. 4:

In order to protect Seller from too great burden under the price provisions of this contract in the event of abnormal inflation of prices of commodities generally, it is agreed that in the event of the happening of the contingencies hereinafter mentioned, an adjustment of the prices to be paid by Buyer to Seller for gas hereunder shall be made as herein provided. Using as a standard the Federal Bureau of Labor Statistics' Annual Index of Wholesale Prices of All Commodities for any calendar year, based upon or adjusted to 1926 prices as 100 and defining the word "point" for the purpose hereof to mean one percent of the 1926 prices, it is agreed that no adjustment shall be made unless and until (1) the Annual Index shall be more than thirty (30) points above the level (104.0) indicated by the Annual Index on December 11, 1945, and (2) Buyer shall have effective rates above 25¢ per Mcf for

gas sold by it for resale. If rates above said 25¢ per Mcf shall be effective during any adjustment period, the price of gas delivered hereunder shall be adjusted to a price which bears the same ratio to the price provided in Section 1 of this Article VIII as the effective rates bear to 25¢ per Mcf. Further proportionate adjustments in the prices hereunder shall be made in the same manner whenever a further revision in the rates of Buyer shall become effective during any adjustment period; provided, that whenever the Annual Index shall be not more than thirty (30) points above the level indicated by said Annual Index on December 11, 1945, or whenever Buyer shall have effective rates equal to or less than 25¢ per Mcf, the prices provided in Section 1 of this Article VIII shall again be in effect. Whenever the Annual Index shall be more than thirty (30) points above said level, Buyer shall diligently pursue all rights and remedies to which it is entitled in a good faith endeavor to bring about, and procure the approval of, an increase or successive increases, as the case may be, in its rates to bring its rates up to the inflated price level. Buyer shall notify Seller in writing within ten days after receipt by Buyer of any revision during any adjustment period in rates for gas sold by it for resale. The term "adjustment period" as used in this Section 2 means the period beginning on the first day of the calendar month following the publication of the Annual Index showing such index to be more than thirty (30) points above the level indicated by said Annual Index on December 11, 1945, and ending on the first day of the calendar month following the publication of the Annual Index showing such index to be less than thirty (30) points above said level. For the purpose of applying the provisions of this Section 2, (a) the effective rates shall be deemed to include only rates for gas sold for resale, and (b) the price of gas delivered hereunder as provided in Section 1 of this Article VIII shall be deemed to be the price provided in said Section 1, exclusive of the provisions relating to the weighted average price of gas in the Panhandle Field and the Hugoton Field. In the event Buyer's rates for gas sold for resale shall not be uniform the effective rates for such sales shall be

deemed to be the weighted average price received by Buyer for all such sales during each calendar month. If for any calendar year an Annual Index is not published on or before April 1 of the following year, the Annual Index shall be deemed to be the arithmetic average of the monthly indices for the twelve months of such calendar year and shall be deemed to have been published in March

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IN THE

Supreme Court of the United States

OCTOBER TERM 1962

No. 74

LONG ISLAND LIGHTING COMPANY,
PHILADELPHIA ELECTRIC COMPANY, and
THE UNITED GAS IMPROVEMENT COMPANY, *Petitioners*,

v.

FEDERAL POWER COMMISSION, *Respondent*.

On Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

BRIEF FOR LONG ISLAND LIGHTING COMPANY, PHILADELPHIA ELECTRIC COMPANY, AND THE UNITED GAS IMPROVEMENT COMPANY

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BRIEF FOR LONG ISLAND LIGHTING COMPANY, PHILADELPHIA ELECTRIC COMPANY, AND THE UNITED GAS IMPROVEMENT COMPANY

OPINIONS BELOW

The opinion of the Court of Appeals (R. 410-430) is not yet reported. The opinion and order of the Federal Power Commission (R. 251-342) are reported at 24 F.P.C. 537, and the Commission's order denying rehearing (R. 395-404) is reported at 24 F.P.C. 1008. The decision of the presiding examiner (R. 35-217) is reported at 24 F.P.C. 590.

JURISDICTION

The judgment of the Court of Appeals affirming the Commission's orders was entered on November 30, 1961 (R. 431-432). The petition for a writ of certiorari was filed on February 28, 1962 and granted on May 14, 1962 (R. 432-434). The jurisdiction of this Court rests on 28 U.S.C. 1254(1) and § 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

STATUTE INVOLVED

The pertinent provisions of the Natural Gas Act, 52 Stat. 821, as amended, 15 U.S.C. 717-717w, provide:

> SEC. 4. (a) All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.
>
> (b) No natural-gas company shall, with respect to any transportation or sale of natural gas subject to the jurisdiction of the Commission, (1) make or grant any undue preference or advantage to any person or subject any person to any undue prejudice or disadvantage, or (2) maintain any unreasonable difference in rates, charges, service, facilities, or in any other respect, either as between localities or as between classes of service.
>
> (c) Under such rules and regulations as the Commission may prescribe, every natural-gas company shall file with the Commission, within such

time (not less than sixty days from the date this act takes effect) and in such form as the Commission may designate, and shall keep open in convenient form and place for public inspection, schedules showing all rates and charges for any transportation or sale subject to the jurisdiction of the Commission, and the classifications, practices, and regulations affecting such rates and charges, together with all contracts which in any manner affect or relate to such rates, charges, classifications, and services.

(d) Unless the Commission otherwise orders, no change shall be made by any natural-gas company in any such rate, charge, classification, or service, or in any rule, regulations, or contract relating thereto, except after thirty days' notice to the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. The Commission, for good cause shown, may allow changes to take effect without requiring the thirty days' notice herein provided for by an order specifying the changes so to be made and the time when they shall take effect and the manner in which they shall be filed and published.

(e) Whenever any such new schedule is filed the Commission shall have authority, either upon complaint of any State, municipality, or State commission, or upon its own initiative without complaint, at once, and if it so orders, without answer or formal pleading by the natural-gas company,

but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the natural-gas company affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect, and after full hearings either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made at the expiration of the suspension period, on motion of the natural-gas company making the filing, the proposed change of rate, charge, classification, or service shall go into effect. Where increased rates or charges are thus made effective, the Commission may, by order, require the natural-gas company to furnish a bond, to be approved by the Commission, to refund any amounts ordered by the Commission, to keep accurate accounts in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts were paid, and, upon completion of the hearing and decision, to order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof

to show that the increased rate or charge is just and reasonable shall be upon the natural-gas company, and the Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible.

Section 5. (a) Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: *Provided, however,* That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural-gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural-gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates.

QUESTION PRESENTED

Whether the Federal Power Commission, for reasons of administrative convenience, may indefinitely defer enforcement of Sections 4 and 5(a) of the Natural Gas Act by refusing to set just and reasonable rates for natural-gas producer sales in accordance with proven and established procedures, because it has chosen to embark upon an entirely new, unformulated and judicially untested method of producer rate regulation, when such indefinite deferral will cause massive and irreparable injury to the consuming public.

STATEMENT[1]

Petitioners are engaged in the distribution of natural gas to some 1,300,000 customers in the New York and Philadelphia metropolitan areas. Petitioners obtain their natural gas requirements from certain interstate gas pipeline companies, which in turn purchase, either directly or indirectly, the major part of their natural gas supplies from independent natural gas producers, including Phillips Petroleum Company. Accordingly, the rates charged by Phillips and other independent producers directly affect petitioners' gas costs and the rates which they must charge the ultimate domestic consumer.

When the Federal Power Commission reinstituted the general investigation of Phillips' rates pursuant to

---

[1] Petitioners have been permitted to read the brief filed in No. 71 by petitioners State of Wisconsin, Public Service Commission of Wisconsin, and Public Service Commission of the State of New York (hereafter Wisconsin-New York brief). Petitioners are in full agreement with the statement appearing at pages 6-15 of that brief, and to avoid burdening the Court with repetitious matter, they would hereby incorporate and adopt that statement, as though fully set out herein.

the mandate of this Court in *Phillips Petroleum Company* v. *Wisconsin*, 347 U.S. 672, petitioners herein were permitted to intervene in the proceedings and participated actively in all phases. Petitioners presented testimony and other evidence bearing on the appropriate methods for determining Phillips' costs (R. 44-45). The regulatory methods sponsored by petitioners were adopted in large part by the Examiner and the Commission in determining Phillips' 1954 costs in its decision here (24 F.P.C. 623-723).

When the Commission in its opinion herein (R. 251, 323-329) determined not to fix Phillips' just and reasonable rates, for past and future periods, on this record (augmented if necessary) and terminated the proceedings, petitioners, together with the States of Wisconsin, New York and California, sought review in the Court of Appeals. That court, Judge Fahy dissenting, sustained the Commission's action abandoning, for an indefinite period, any effort to regulate the rates of Phillips, as well as other major independent gas producers, under Sections 4 and 5(a) of the Natural Gas Act.

SUMMARY OF ARGUMENT

I. This Court in its *Phillips* decision directed Respondent to regulate independent producers under Sections 4 and 5(a), the rate provisions of the Natural Gas Act. Respondent for several years sought to obtain legislation reversing the *Phillips* mandate. When it failed in this, it initiated combined Section 4(e) and 5(a) investigations of the rates of the twenty four largest producers which sell at wholesale over half of the gas in interstate commerce. Most of these cases were in advanced stages when Respondent terminated

the *Phillips* proceeding announcing its intention of abandoning individual major producer rate regulation. Respondent's stated reason was that since it intended to shift to another (and presumptively better) form of regulation, it would not be feasible to continue the major producer Section 4-5(a) cases.

Respondent's decision to abandon an existing and viable form of regulation before the gestation of any substitute has resulted in a complete suspension of producer regulation under Sections 4 and 5(a) of the Gas Act for an indefinite period. Since initiation of the major producer proceedings, Respondent has not decided a single Section 5(a) case of any consequence. With a few exceptions, it has not determined the validity of any rate increase under Section 4 of the Gas Act. Respondent has admitted that it will be many years before its proposed "area" regulation could be effective. It is certain, therefore, that this deliberate hiatus in regulation will continue for a long and indefinite period.

II. Petitioners do not seek to force a particular method of regulation on Respondent, and in fact affirmatively support the "area" proceeding experiment as a possible long range solution to producer rate making problems. As public utilities, however, Petitioners must be concerned that their existing customers receive protection against current, sharply increased field price levels. Respondent offers only its powers over initial rates under Section 7, and its practice of subjecting rate increases to possible refund under Section 4(e), as an interim substitute for the protection of lawful rates tested under Sections 4 and 5(a) contemplated by the Gas Act. Neither power offers adequate protection to consumers; nor is either a valid substitute

for the effective rate regulation contemplated by Congress.

A. Respondent admittedly has not and will not determine the lawfulness of producer rate increases for the indefinite future, but will merely subject them to a potential refund obligation, now accumulating at the rate of approximately $158 million a year. The fact that this amount is theoretically refundable does not mean that consumers are protected against these increased and possibly unlawful rates. Much experience with pipeline regulation demonstrates that when refunds are accumulated over long periods, it is practically or politically impossible to obtain restitution of the entire amount found unlawful; and a compromise is effected to avoid bankrupting the regulated company. Even assuming that full refunds could be obtained, Respondent has admitted to this Court that consumers are entitled to current protection against unjustified rates, not merely the expectation of refunds—possibly to other consumers—sometime in the future.

B. Further, Respondent's Section 4(e) refund powers cannot reach many high, non-refundable rates authorized by the Commission under an erroneous view of its responsibilities, before *Atlantic Refining Co.* v. *Public Service Commission of New York*, 360 U.S. 378, and decisions following that case. While Respondent now employs its so-called SGP61-1 rate levels to condition initial rates, these rate levels were promulgated without hearings or findings, and represent the highest level reached by interstate rates in each producing area after five years of non-regulation. Hence, they are manifestly not "just and reasonable" rates, but merely a stop-gap "hold the line" device to prevent a

further rise in field prices. Reliance on these levels would not prevent consumers from paying indefinitely sharply increased and probably unlawful rates, which are not refundable even in theory. It follows that only affirmative application of Section 5(a) will provide protection against these existing rates; but this, as we have seen, Respondent has put aside indefinitely.

Respondent of course has discretion to select a regulatory method. Where Congress has told it to regulate, Respondent does not have discretion to decline indefinitely to regulate, in order to meet its administrative problems. This generation of consumers as well as the next is entitled to protection.

III. A. Decision of the almost completed major producer cases would provide substantial protection to consumers pending development and application of an area method of regulation. These cases, as pointed out, involve rates covering over 50% of interstate gas wholesales, and establishment of just and reasonable rates for this volume of gas would profoundly affect existing rate levels. Respondent's order here leaves no doubt that it is entirely feasible to decide these cases, and many of them have already been decided by Respondent's trial examiners. The cost information derived from the cases would provide both a check and a foundation for future area rates.

B. The existing Section 4-5(a) cases, furthermore, offer the only feasible way at this time of applying the Gas Act rate standards to producer rates. As stated, these cases are virtually completed, and no substitute method has been formulated, much less applied. The court below mistakenly assumed that Respondent's stop-gap SGP61-1 rate levels *were* "just and

reasonable" rates, despite Respondent's clear and repeated disavowals. Actually, these rates, as has been pointed out, in each instance represent only the highest, untested field price previously authorized by Respondent, and were issued without hearing or findings. Hence, it seems clear that they would meet neither the substantive standards of the Gas Act nor the standards of procedural due process, if used to set lawful rates.

It follows that Respondent has abused its discretion in abandoning a viable, although possibly imperfect, method of applying the Act's rate provisions which would provide substantial consumer protection, before a working substitute is at hand.

ARGUMENT

I

RESPONDENT HAS UNLAWFULLY DEFERRED APPLICATION OF THE RATE PROVISIONS OF THE NATURAL GAS ACT TO INDEPENDENT PRODUCERS FOR AN INDEFINITE PERIOD

Respondent has left no doubt that it has deliberately deferred regulation of producer field prices under Sections 4(e) and 5(a) of the Natural Gas Act (*supra*, pp. 3-5) for an indefinite period. It has implied this in its order here (R. 256-269, 397), and it has decided virtually no producer cases under these sections since that order issued (see *infra*, p. 12). Pending fruition of its area approach to producer rate making, Respondent has deferred any attempt at positive regulation, seeking only to "hold the line" by conditioning producer "initial" prices under Section 7 of the Act (Br. Opp. p. 11). Respondent's reasons for abandoning one form of regulation before a substitute is available have not been fully articulated (see Br.

Opp. pp. 15-19; R. 262). However, one surmises that Respondent decided to abandon the individual Section 5(a) cases in order to restrict its work load so as to facilitate its long range experiment in "area" rate making. This amounts to making one generation of consumers pay for speculative benefits to a later one.

The Gas Act contemplates *effective* rate regulation, not merely a facade of regulation which provides no real consumer protection. *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672, 682-3; *Atlantic Refining Co.* v. *P.S.C. of New York*, 360 U.S. 378, 388. Respondent may argue, as it has in its brief opposing certiorari (p. 10), that it is not actually deferring producer rate regulation; that it has merely shifted to another permissible regulatory form. However, regulation under Section 4(e) of the Natural Gas Act (*supra*, p. 3) implies at a minimum investigations of filed rate increases, determination of "just and reasonable" nondiscriminatory rates, and the ordering of refunds where required. Section 5(a) regulation (*supra*, p. 5) similarly requires the prescription of future lawful rates. While the procedures followed in taking these steps could certainly vary, these are the minimum and essential steps in applying the standards imposed by Sections 4(e) and 5(a).

The Commission has not held a hearing on, much less decided, a single *Phillips* Section 4(e) increase since 1956 despite the 83 additional rate increases filed by that company, aggregating $22 million annually (App. B, *infra*, p. 37). It has also terminated Phillips' Section 5(a) case on the basis of 1954 cost despite a more than 50% increase in unit revenues since that

time.[2] Similarly, Respondent, with a few exceptions,[3] has not held hearings on the vast majority of pending individual producer Section 4(e) increases, despite the fact that, as we show *infra*, these now aggregate $158 million annually. It has not decided a single producer Section 5(a) case of any consequence. If this is not a deferral of producer rate regulation, it is difficult to understand what *less* Respondent could have been doing in this period.

This demonstrated hiatus in regulation has been going on for a number of years, and will certainly continue until such time as the area rate method has been formulated, judicially approved, and becomes a working reality. The court below recognizes that the various area proceedings may take from four to fourteen years to complete (R. 422). Respondent's Chairman, testifying before a subcommittee of the House Appropriations Committee on February 26, 1962, stated

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[2] As Judge Fahy points out (R. 429):

> "Unless decided Phillips challenged rates are left undetermined under the standards of the Act since 1948, and apparently will continue to remain undetermined until some future day when new proceedings, now in an inchoate state with no end in sight, are concluded."

[3] Respondent has in effect ordered hearings on those major producer Section 4(e) increases which have been consolidated with the Section 5(a) rate investigations (see App. A, *infra*, p. 33, and *infra*, pp. 16-20). However, its order here indicated that it would terminate these proceedings without a determination of just and reasonable rates. Respondent has also directed hearings in a small number of individual Section 4(e) rate filings which presented the possibility of widespread triggering of other producer rate increases as a result of so-called "favored nation" clauses which are prevalent in producer contracts. See, e.g., *Union Producing Co.*, 24 F.P.C. 841.

(Hearings, Committee on Appropriations, House of Representatives, *Independent Offices, 1963*, p. 573):

> "MR. SWIDLER. With respect to the producer cases, we are launching into what is really an important experiment in administrative devices in the area rate proceedings. Each of the two area rate proceedings which have been established involves a consolidation of literally hundreds of cases.
>
> "You would not expect that these cases which involve the fundamentals and the economics and finances of the natural gas side of the petroleum industry would move with great speed. They have not.
>
> "We are now using the *Permian Basin* case as the lead case for lack of personnel and no other reason. We are unable to make the same progress in the second of these proceedings, the *Southern Louisiana* case.
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> "These are the two most important natural gas production areas. If we can set a pattern in these two cases, then they will move faster, and I think we are making progress, but it is progress in such a tremendous proceeding that it is progress that cannot be measured in days or months. It will take a year or two probably before we could hope to come out with the answer in the *Permian Basin* case.
>
> "On the *Louisiana* case, we would not really make a strong start until we get the money."

It should be borne in mind that the Permian and South Louisiana areas are only two of the twenty-three areas designated by Respondent in its SGP61-1 order (R. 348). Given the inevitability of judicial review of any order concluding these proceedings, the times suggested by the Court of Appeals are hardly exaggerated.

Petitioners have actively supported the area rate making approach as a long-range solution to many of the problems of producer rate making, on the key assumption that area rates will reflect the costs of producing gas so as to avoid windfalls to producers. Far from seeking to force a particular regulatory method on Respondent, Petitioners are concerned that the area proceedings be given every opportunity to develop into an effective program of field price regulation. Petitioners, as public utilities, are equally concerned, however, with the impact of four to fourteen years of non-regulation on their customers and themselves, even if they could be assured of effective regulation after that time. They shall show in section II, *infra*, that this impact is likely to be severe and irreparable.

As Judge Fahy emphasized repeatedly in dissenting (R. 427-430), while Respondent's discretion is broad, it cannot lawfully make the choice it apparently has made. Its lawful discretion does not permit the deliberate sacrifice of present consumer interest in a problematic effort to ease the regulatory burden, by suspending *pro tem* the application of Sections 4(a), 4(b), 4(c) and 5(a) of the Natural Gas Act to gas producers which make wholesales in interstate commerce. *Schaffer Transportation Co.* v. *United States*, 355 U.S. 83, 88-91; *American Trucking Ass'ns* v. *United States*, 355 U.S. 141, 149-150.

II

GAS CONSUMERS WILL BE SEVERELY INJURED BY THE HIATUS IN REGULATION RESULTING FROM RESPONDENT'S ORDER

There is an acute need for present, effective regulation of producer field prices which cannot be met despite Respondent's contrary suggestion (Br. Opp. 16-17) merely by subjecting mounting rate increases to

possible refund, and periodically conditioning initial rates. The price of non-regulation will be inevitable consumer injury.

A. Respondent's Refund Powers Offer Inadequate Protection Against Mounting Producer Increases

Phillips' current Section 4(e) increases subject to refund aggregate $22 million on an annual basis (App. B, *infra*, p. 37); and the cumulative amount undoubtedly is several times this figure. The total amount of producer rates now subject to refund has reached the staggering sum of $158,000,000 on an annual basis (1961 FPC Annual Report, p. 80) and the cumulative amount probably exceeds three quarters of a billion dollars.[4] If the rates governing only those sales involved in the Permian Basin area rate proceeding were reduced on an average by one penny, the total refund would approximate $8,600,000 (Exh. 118, FPC Dk. No. AR61-1).

The fact that these amounts are theoretically refundable does not mean that consumers are currently protected by the Commission's Section 4(e) powers. In the first place, experience in pipeline regulation has shown that when sellers are permitted over long periods to collect sums of this magnitude based on refundable rate increases, it is practically and even politically impossible to obtain full refunds, even if the rates are subsequently found unlawful.[5] Thus, while Respond-

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[4] These figures include only the increased portion of the rates in question, and are not based on the assumption that the entire revenues are refundable.

[5] This well recognized fact places pressure on consumer representatives to make concessions to the seller rather than pay indefinitely the increased rates.

ent argues (Br. Opp. 19) that $74 million in Phillips' annual revenues is refundable, it staggers belief to assume that Respondent could or would make Phillips refund such an amount at one time, when these revenues have been absorbed into its business, and its operations and expansion based upon them for many years.[6] A classic instance of this practical limitation on the power of a regulatory body concerned a major natural gas pipeline company which faced bankruptcy as a result of accumulated refunds resulting from Respondent's inaction in passing upon its rate filings. As the Subcommittee on Legislative Oversight pointed out:

> "Because of the tremendous backlog of rate cases, the Commission has adopted the expedient of negotiating settlements of these rate cases, many of which involve scores of millions of dollars. In this situation the companies have the superior bargaining position. In one case, the *Colorado Interstate Gas Company* case, dockets Nos. G-2260, G-2576, and G-11717, the company used a plea of possible bankruptcy if the hearing examiner's recommendation was to be followed. There the hearing examiner had found the company's rates to be unjust and unreasonable and had his recommendations been carried out the company would have had to refund approximately $45 million. Upon its allegations to the newspapers that such an order would bankrupt the company, Commissioner Kline, one of the Commissioners who would have to participate in the final adjudication of the amount of the refund, participated in negotiating a settlement (Staff report, p. 92)." (Report,

[6] It is important to keep in mind that Respondent does not require segregation of amounts collected subject to refund. Such amounts can be treated in all respects indistinguishably from ordinary revenues (18 C.F.R. 154.102).

Special Subcommittee on Legislative Oversight, House Commerce Committee, January 3, 1961, p. 27.)

Secondly, even assuming that adequate refunds could be made, Respondent has recently argued in this Court that such refunds provide no protection to many consumers:

> "The decision [for which review is sought] seems to rest largely on the erroneous view that consumers are fully protected, albeit they continue to pay excessive rates, by the pipeline's ultimate obligation to refund the excess charges with interest. But, as the Commission has recognized, the protection afforded by refund provisions is by no means complete. Ours is a mobile society; those consumers of natural gas who pay excessive rates in a given area today are scattered as the months go by. For the ordinary consumer, even if he does not move, a daily increase in his cost of living is not offset by the prospect of receiving a lump sum sometime in the future. The Court has encountered this problem in the cases dealing with the disposition of funds impounded as a result of judicial stays of Commission rate reduction orders. Moreover, the inflationary impact of present day high rates is scarcely relieved by the possibility of refunds at an indeterminate date in the future." *F.P.C. v. Tennessee Gas Transmission Co., et al.*, No. 48 this term, Petition of Federal Power Commission for Writ of Certiorari, pp. 10-11. [Footnotes and citations omitted.]

Finally, a paramount aim of public utility regulation is to provide stability and predictability in the cost of basic community services. The prolonged collection of refundable rates throws into doubt the fundamental cost patterns of the gas distribution industry.

The expectations of people making business decisions within the industry and of the investing public are bound to be influenced by the price being paid, even though there is a statement—and the notation is all too often omitted—that the price is in dispute. As Respondent has pointed out in its recent prepared statement to the House Appropriations Committee (Hearings, *supra*, at 540, 589):

> "The welfare of the natural gas industry is also at stake. The inability of the Commission to master its problems with the techniques and funds heretofore available has resulted in over a billion dollars in rates which have been suspended. The pipelines and the producers are passing these charges along subject to refund. The consumers are paying the money but the industry suffers also. They do not know how much of the money they have taken will ultimately be determined to belong to them. They are handicapped in their financing and in the sale of their securities. It is true that the unprecedented difficulty of the problems of regulation of the producers provide an excuse for the delays of regulation by the Federal Power Commission. Nevertheless, this is a responsibility which the Federal Government has assumed and which it is honor bound to discharge.
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> * * * * *
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> "Delay in disposition of suspended rates causes hardships on both consumers and companies. The ownership of million of dollars collected from distributors and in turn from consumers under suspended rate schedules remains in doubt. Under such circumstances the companies may find it difficult to raise funds necessary for expansion since their financial status is in doubt until the rate cases are concluded. Rate payers are denied the use of funds collected as excessive rates."

The Natural Gas Act expressly recognizes this danger when it requires (Section 4(e), *supra*, p. 5) that Respondent "give to the hearing and decision of [rate] questions preference over other questions pending before it and decide the same as speedily as possible."

Hence, the mere piling up of refundable producer revenues is no substitute for the expeditious application of the Section 4(a) and 4(b) standards to increased rates filed under Section 4(e). Yet this is absolutely all Respondent offers as interim protection under the "just and reasonable" standard, pending the coming, hopefully, of definitive area rates.

B. Gas Consumers Will Be Severely Injured By Existing High, Non-Refundable Rates as a Result of the Indefinite Deferral of Regulation Under Section 5(a) of the Act

Respondent has a statutory charge not only to pass upon the validity of rate increases but upon complaint or its own motion to investigate the lawfulness of existing, non-refundable rates under Section 5(a) of the Natural Gas Act.

Respondent's decision to defer indefinitely the testing of existing major producer rates under Section 5(a) of the Act has had and will have until corrected a severe adverse impact on gas consumers. As this Court knows, Respondent beginning in 1956 authorized under Section 7 of the Act a large number of extremely high priced sales without rate conditions, under the mistaken view that it had no responsibility for initial rate levels. *Atlantic Refining Co.* v. *Public Service Commission of New York*, 360 U.S. 378 (1959); *Public Service Commission of New York* v. *FPC*, 361 U.S. 195 (1959); *United Gas Improvement* v. *FPC*, 283 F. 2d 817 (9th Cir. 1960), *cert. denied*, 365 U.S. 879,

881; *Public Service Commission of New York* v. *FPC*, 287 F. 2d 146 (D.C. Cir. 1960), *cert. denied*, 365 U.S. 880, 882; *Public Service Commission of New York* v. *FPC*, 287 F. 2d 143 (D.C. Cir. 1960); *United Gas Improvement* v. *FPC*, 287 F. 2d 159 (10th Cir. 1961); *United Gas Improvement* v. *FPC*, 290 F. 2d 133 (5th Cir., 1961), *cert. denied*, 368 U.S. 823; *United Gas Improvement* v. *FPC*, 290 F. 2d 147 (5th Cir., 1961), *cert. denied*, 366 U.S. 965. Respondent has belatedly recognized its error, and its obligation insofar as possible to undo the resulting injury to consumers, stating:

> "* * * Obviously the substantive errors were ours in accepting the arguments propounded by the producer-applicants; equally obvious, the New York Public Service Commission and the Eastern Seaboard Companies have consistently, publicly, and in the final analysis successfully urged the error of these arguments. The courts having lain bare the errors, it remains our task equitably to correct them. See *Ford Motor Company* v. *N.L.R.B.*, 305 U.S. 364.
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> * * * * *
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> "* * * Patently, our unconditional certificate order was erroneous in law and could not have been sustained on judicial review had we failed to grant rehearing. Having granted rehearing we should voluntarily correct the error just as if the courts had compelled us to do so. See *Ford Motor Co.* v. *N.L.R.B.*, 305 U.S. 364, 375." (Order Denying Rehearing, *Texaco-Seaboard Inc., et al.*, Docket Nos. G-13169, *et al.*, March 7, 1962).[7] [Footnote omitted]

Although Respondent is thus attempting to protect the public in those few initial service cases which have

[7] This order was issued on remand ordered in *Public Service Commission of New York* v. *FPC*, 361 U.S. 195.

been appealed, unfortunately it has also authorized a substantial number of extremely high priced sales which, not being appealed, have never been tested under the standards either of Section 7 or Section 5(a) of the Act. Thus, Phillips is at present making sales at non-refundable rates which produce revenues exceeding by $3,000,000 annually those which would be produced if its rates were consistent with Respondent's increased field price levels in SGP61-1 (App. C, *infra*, pp. 38-40).[8] Respondent's decision here postpones indefinitely any scrutiny of the lawfulness of these rates under Section 5(a) of the Gas Act. Such scrutiny when it does come will, of course, only be prospective in nature. *Atlantic Refining Co.* v. *Public Service Commission of New York*, 360 U.S. 378, 389.

It is true that Respondent is now—though not earlier—testing Phillips' proposed initial rates under its SGP61-1 "initial" rate levels (R. 348). However, these levels, as we show *infra*, pp. 29-32, are merely the highest untested, previously authorized rates in each area, and are not necessarily "just and reasonable" and "non-discriminatory" rates.

The situation is even more extreme for the major producers as an aggregate. Taking South Louisiana as an example, Appendix D (*infra*, [illegible]) shows that over 55% of South Louisiana "jurisdictional" gas is now flowing at prices which exceed Respondent's current "initial price" ceiling (R. 348)! Over 94% is flowing at prices which exceed Respondent's "increased price" ceiling, which has thus become a complete dead

[8] The annual revenues from the new rates not subject to Section 4(e) refunds exceed those which would be produced by Respondent's initial field price levels by $480,000 (App. C, *infra*, pp. 38-40).

letter. Over 70% is flowing at prices which exceed the price Respondent found "in line" for the so-called CATCO gas, on remand from this Court's decision in *Atlantic Refining Co.* v. *P.S.C. of New York*, 360 U.S. 378 (*Continental Oil Co., et al.*, Docket Nos. G-11024, 27 F.P.C. . . .). Thus, even accepting Respondent's completely untested SGP61-1 price levels (but see Wisconsin-New York Br. 29-33, and *infra*, pp. 29-33), field prices have long since vaulted above these levels in South Louisiana, which is today the most important of Respondent's gas production areas.

It should be realized that gas consumers *cannot* be protected against these questionable prices by Respondent's refund powers since much of these revenues are not refundable, even in theory. Of the total 1960 revenue received by the 13 major producers whose Section 5(a) rate cases are near completion, about $250,000,000 (roughly 83 per cent) is now being collected not subject to any refund obligation (Wisconsin-New York Br., App. A, p. 49). A very substantial percentage of this non-refundable revenue is derived from sales at prices in the 20 to 24 cent range which exceed the applicable Commission area price levels (R. 348); and almost all is derived from rates which represent sharp increases over average price levels in the particular area (*ibid.*). Such sharply increased prices are *prima facie* suspect and in all probability unlawful.

Taking South Louisiana again as the most important example, nearly one-third of 1960 jurisdictional sales by the foregoing 13 producers at prices in excess of 21.25 cents per Mcf (Respondent's current initial price "ceiling") are probably not subject to refund. These sales aggregate approximately 436,000,000 Mcf, or 38 per cent, of total South Louisiana sales above this price level which amounted

to 1,128,000,000 Mcf (App. D, *infra*, p. 42).[9] It should also be noted, as previously stated, that 90 per cent of the *total* 1960 sales volume in South Louisiana was sold at more than 16 cents per Mcf, which is approximately the Commission's current South Louisiana "old gas" ceiling of 15.75 cents derived a few years earlier as an *average* price in this area. (R. 348; App. D, *infra*, p. 41).

While it is impossible, of course, to compute the exact amount of total jurisdictional revenues which is probably being collected unlawfully and without possibility of refunds, there can be no doubt that the amounts are of enormous magnitude.

We have seen, *supra*, that the Section 4(e) refund power provides totally inadequate protection against unjustifiable rate increases.[10] However, the only rem-

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[9] The condition of F.P.C. records makes it impossible to do more than estimate the exact jurisdictional volumes being sold not subject to refund, since the only available data are derived from the pipeline "Form 2" reports which do not invariably segregate jurisdictional and intrastate sales. Hence, the foregoing figures (and those in Appendix D, *infra*, p. 42) may overstate the jurisdictional revenues not subject to refund, and must be taken as approximations. However, the actual volumes sold not subject to refund would be of the same order of magnitude.

[10] As Respondent stated in a recent order (*Texaco Inc.*, Docket Nos. G-13169, *et al.*, July 30, 1962, p. 4):

> "• • • In recent years sellers and buyers of gas produced in the South Louisiana area have been plagued by an unusually high measure of uncertainty as to price. Such uncertainty injures all interested segments of the public. For the prices which a producer can charge and may retain largely determine the costs he can reasonably incur; and the public relies upon intelligent planning, vigorous enterprise, and repeated new investments by independent producers. Drastic uncertainties as to price impair the producer's ability soundly to undertake new ventures and thus constrict his capacity to serve the public." [Footnote omitted]

edy of any kind for these high, non-refundable prices lies in Respondent's Section 5(a) prospective rate testing powers, but these, as we have seen, have been laid aside indefinitely. Thus, the Commission's deferral of regulation under Section 5(a), if permitted to continue, will result in a significant and irretrievable increase in basic fuel costs borne by the ultimate consumer, wholly without consideration as to whether such an increase is consistent with the standards of the Natural Gas Act.

It follows that gas consumers will be injured, and severely injured, if Respondent continues in its attempt to solve its administrative difficulties by abandoning an existing form of regulation prior to the gestation of any substitute. While Respondent has discretion to choose a regulatory method, it does not have discretion to decline to regulate a class of natural gas companies Congress has said it should regulate. *Office Employees Int'l Union* v. *N.L.R.B.*, 353 U.S. 313 (1957); *Hotel Employees Local* v. *Leedom*, 358 U.S. 99 (1959), holding that the Labor Board abused its discretion in declining to apply the Labor Management Relations Act to specified classes of employees.[11] See also *I.C.C.* v. *U.S. ex rel. Humbolt Steamship Co.*, 224 U.S. 474, 484.

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[11] The Labor Board has jurisdiction over unfair labor practices "affecting commerce" (29 U.S.C. 160(a)), so that presumably it has some area of discretion in determining what comes within this standard. See *Optical Workers Local* v. *N.L.R.B.*, 227 F. 2d 687 (5th Cir. 1955), *cert. denied*, 351 U.S. 963, and 29 U.S.C. 142(1). Respondent, to the contrary, is directed to regulate *all* wholesales in interstate commerce regardless of their "effect", and *a fortiori* does not have the discretion to exempt a class of wholesale sellers.

III

DECISION OF THE PENDING MAJOR PRODUCER SECTION 5(a) CASES OFFERS THE ONLY PRACTICAL AND AVAILABLE METHOD OF INTERIM RATE REGULATION

Respondent, as we have seen, has refused as a matter of regulatory policy to determine the lawfulness of Phillips' current rates, on the ground that this can properly await the outcome of the area rate proceedings. We have shown that such a deferral of regulation will seriously injure gas consumers. We shall show below that testing Phillips' and other major producers' current rates against the standards of the Natural Gas Act would in fact provide substantial interim protection to gas consumers during the indefinite period pending development of effective area rates—protection which can be provided, practically speaking, in no other way.

A. Decision of Section 5(a) Cases Would Provide Substantial Consumer Protection and Further Respondent's Long-Range Program of Producer Regulation

Hearings have been completed in twelve major producer Section 5(a) cases involving (with Phillips) about 32% of current interstate sales by volume of gas (App. A, *infra,* p. 33). Examiners' decisions have been issued in four of these cases, and three have recently been settled resulting in reductions in existing rates and refunds for past periods (App. A, *infra,* p. 33). In addition, Respondent has completed its field investigation of five more major producers whose sales by volume when added to the foregoing thirteen encompass about one-half of all interstate gas (App. A, *infra,* p. 33).

There is no doubt that Respondent could decide these cases, as is evidenced by its decision in *Phillips* and

the four examiners' decisions applying the *Phillips* methods. As Judge Fahy has pointed out in dissenting (R. 427, 429-430):

> "These cases need not be treated as if they were ventures initiated in search of an ideal method of regulating the rates of independent gas producers. Having in mind the history of these proceedings, and the primary congressional purpose of consumer protection, it seems to me that decisions on the present record, supplemented as may be found to be reasonably necessary, would be far more likely to approximate fulfillment of the purposes of the Act than are the termination order and the resulting situation.
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> "The Commission has actually found Phillips' cost of service on the basis of the record made and has arrived on the same record at a proper rate of return, stating 'this is clearly a lawful way to determine rates for Phillips as illustrated by the *City of Detroit* case, . . . and under the present record is the only possible method . . .' In this manner the Commission has come so close to doing what it says it should not do as to demonstrate that it is able to do what it has failed to do."

Decisions in Phillips and in the other cases involving about one-half of interstate gas would provide substantial interim protection during the possibly extended period before area rates can be made effective. If the trial examiners' findings are any guide, such decisions would result in substantial across-the-board reductions in existing high rate levels, refunds under Section 4(e) of large amounts unlawfully collected, and elimination of unduly discriminatory rate differentials. These results would of course provide significant benefits to gas consumers in themselves. Even more important collateral benefits could be expected. The

determination of lawful rates governing such a large percentage of regulated sales would undoubtedly stabilize field prices for some time in the future, and also substantially ease Respondent's burden in dealing with pending and new Section 4(e) increases. Such decisions by laying a firm ground work of regulatory principles would facilitate conclusion of rate cases of other producers.

Finally, the establishment of cost-based lawful rate levels for major producers would provide both a test and foundation for future area rates. By easing the strong upward pressure on existing rate levels, such decisions should greatly facilitate the application of area rates which actually reflect producer costs, rather than merely the play of market forces (see *infra*, p. 30). Through establishing the costs of producing gas over a wide variety of areas on a clearly lawful basis, they should provide a standard against which the lawfulness of area rates can be tested.

It is recognized, of course, that Respondent has broad discretion to select a regulatory method. The point here is that Respondent has already exercised that discretion in embarking over six years ago on the major producer rate investigations; as a result, as the dissenting judge has recognized (R. 429) this is now the only workable method presently available for applying Sections 4(e) and 5(a) to producer rates. This does not mean that Respondent can never abandon a method or approach once adopted, but rather that it cannot simply suspend regulation indefinitely in the process of changing course. It follows that there is no alternative to deciding the major producer cases, if Respondent is to regulate producer rates at all during this period.

Inasmuch as decision of the major producer cases would provide substantial protection to gas consumers, Respondent abused its discretion in deciding in Opinion No. 338 to abandon abruptly these cases.

B. Respondent Would Deny Procedural Due Process and Violate the Substantive Standards of the Natural Gas Act If It Sought to Use Its SGP61-1 Price Levels to Set Just and Reasonable Rates

We have shown that decision of the pending Section 5(a) cases would provide substantial consumer protection pending the development of area rates. Decision of these cases is also the only means of providing protection at the present stage of producer regulation.

The court below recognizes that there is a "need for interim regulation" (R. 422). It appears to hold (R. 424, 426) that the present SPG61-1 price levels provide adequate interim rate protection, because they can be used to test the lawfulness of rate increases under Section 4(e) and of high existing rates under Section 5(a). Respondent, of course, has always disclaimed any such use of these prices (R. 343). Since the prices were issued without notice, hearing, or findings, there would appear to be substantial due process problems in employing them to set lawful rates. *Ohio Bell Telephone Co.* v. *Public Utilities Comm'n of Ohio*, 301 U.S. 292; *Colorado-Wyoming Gas Co.* v. *FPC*, 324 U.S. 626, 633-635; *I.C.C.* v. *J-T Transport Co.*, 368 U.S. 81. It follows that the SGP prices, in Respondent's view and in actuality, are useful only in piling up refundable rate increases and conditioning initial rates. This, as we have seen, is no substitute for the actual application of the rate standards of Sections 4 and 5(a).

Furthermore, the Wisconsin and New York Commissions (Br. 29-33) have demonstrated that the SGP61-1 price levels represent nothing more or less than the untested field prices collected in each area in 1959, each "initial price" being the highest certified price and each "increased price" being the average price in each area.

Reliance on untested field price data would, of course, amount to abandonment of rate regulation in any conventional sense, since the play of market forces would be permitted to determine "just and reasonable" and "non-discriminatory" rates. The Natural Gas Act constitutes a legislative finding that public regulation must supplement competition in the marketing of natural gas to ensure fair price levels. *United Gas Improvement Co.* v. *F.P.C.*, 290 F. 2d 133, 135 (5th Cir. 1961). The gas producers with Respondent's support[12] have repeatedly, and unsuccessfully, sought to amend the Act to reverse that finding by substituting a "fair field price" standard.[13]

The court below (R. 424), seems to suggest that Respondent need not ascertain a producer's costs or financial requirements, since Respondent can use its "expertise and data on the whole of the market operation" to "evaluate" the prices set by the unregulated

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[12] Respondent has always recognized the necessity of amending the Act in order to return to the free market conditions existing prior to *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672. See fn. 13ff.

[13] The details are set forth in Respondent's annual reports: 1955, p. 177; 1956, pp. 10, 16, 19; 1957, pp. 25-26; 1958, pp. 15-18; 1959, pp. 12-19; 1960, p. 17.

market. However, even assuming that Respondent would be able to do this, the purpose of the Natural Gas Act is to prevent the producers of a commodity in limited supply from collecting exorbitant profits or economic rents from captive customers. *Sunray Mid-Continent Oil Co.* v. *F.P.C.*, 364 U.S. 137, 147. Determination of producer costs or financial requirements is obviously a necessary step in measuring producer profits, since this cannot be done merely from comparison of field price levels. Thus, although many other factors can and should affect a producer rate ultimately set by Respondent, it is necessary at the beginning to find out whether the existing level of field prices yields exorbitant, fair or inadequate revenues when compared with financial requirements.

The District of Columbia and Fifth Circuits for this reason have repeatedly held that Respondent cannot rely on field prices alone in setting rates under Sections 4(e) and 5(a), even when the prices are "evaluated" by expert testimony regarding price trends, production incentives, commodity demands and the like. *City of Detroit* v. *F.P.C.*, 230 F. 2d 810 (D.C. Cir. 1955), *cert. denied*, 352 U.S. 829; *Mississippi River Fuel Corp.* v. *F.P.C.*, 252 F. 2d 619 (D.C. Cir. 1957), *cert. denied*, 355 U.S. 904; *Episcopal Theological Seminary* v. *F.P.C.*, 269 F. 2d 228 (D.C. Cir. 1959), *cert. denied*, 361 U.S. 895; *Bel Oil Co.* v. *F.P.C.*, 255 F. 2d 548 (5th Cir. 1958), *cert. denied*, 358 U.S. 804; *Forest Oil Co.* v. *F.P.C.*, 263 F. 2d 622 (5th Cir. 1959); and *United Gas Improvement Co.* v. *F.P.C.*, 290 F. 2d 133 (5th Cir. 1961), *cert. denied*, 368 U.S. 823. Respondent, so far as we have been able to ascertain, has at all times acquiesced in these decisions.

It follows that although the court below appears to have held that the SGP61-1 prices represent just and reasonable rate levels, such a conclusion is inconsistent both with procedural due process and the substantive requirements of the Natural Gas Act. If the Court of Appeals has not so held, then its opinion fails to explain how Respondent, in the event it is permitted to terminate the existing, consolidated Section 4(e)-5(a) proceedings, will be able to apply the rate standards of the Act to Phillips and other major producers during this interim period.

CONCLUSION

For these reasons, it is respectfully requested that the opinion below be vacated, and that the Court of Appeals be directed to remand the cause to Respondent with instructions to reopen the proceedings, determine the lawfulness of Phillips' current rates and set future lawful rates, and order refunds of any amounts unlawfully collected during past periods under those rates subject to refund.

Respectfully submitted,

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APPENDIX A

Current Status of Major Independent Producer Consolidated Rate Cases Initiated by FPC

Producer	1960 Direct Sales to Interstate Pipelines: Volume mmcf	Volume: Cumulative Per Cent of Total Industry	Revenue: Thousand Dollars	Revenue: Cumulative Per Cent of Total Industry	Section 4(e) Increases Pending as of 12/31/61: Thousand Dollars	Section 4(e) Increases Pending as of 12/31/61: Cumulative Per Cent of Total Industry	Rate Case: Date Instituted	Rate Case: Docket Number	Status
Phillips Petroleum Co.	688,730	8.50%	$ 98,402	7.78%	$ 27,893[1]	16.29%	10/ 2/48	G- 1148	On Review Supreme Court
Pan American Petroleum Corp.	443,089	13.96	63,356	12.78	4,468	18.90	1/27/56	G- 9279	Field Investigation Completed
Humble Oil & Refining Co.	330,560[2]	18.04	58,213[2]	17.38	9,438[2]	24.41	1/27/56	G- 9287	Field Investigation Completed
Gulf Oil Corp.	316,520[3]	21.94	48,089[3]	21.18	10,406[3]	30.48	2/12/59	G-17813	Awaiting Examiner's Decision
Shell Oil Co.	303,404	25.69	57,385	25.72	12,874	38.00	2/11/60	R160-111	Settled August 1, 1962
Texaco, Inc.	260,263	28.90	46,392	29.39	5,361	41.13	5/25/55	G- 8969	Awaiting Examiner's Decision
Cities Service Co.	241,714[4]	31.88	31,809[4]	31.90	5,875[4 5]	44.56	6/24/57	G-12780	Awaiting Examiner's Decision
Socony Mobil Oil Co., Inc.	217,567[6]	34.56	32,634[6]	34.48	10,145[6]	50.48	4/15/57	G-12401	Field Investigation Completed
The Atlantic Refining Co.	205,622	37.10	30,255	36.87	5,579	53.74	1/27/56	G- 9283	Field Investigation Completed
Union Producing Co.	193,479	39.49	24,721	38.82	3,387	55.72	4/29/59	G-18354	Awaiting Commission's Decision
The Superior Oil Co.	192,371	41.86	37,594	41.79	7,880	60.32	6/ 4/57	G-10501	Field Investigation Completed
Sun Oil Co.	156,411	43.79	25,086	43.78	3,181	62.18	4/29/59	G-18353	Awaiting Examiner's Decision
Champlin Oil & Refining Co.	146,791	45.60	20,035	45.36	12	62.18	1/27/56	G- 9277	Settled, 23 FPC 861 (1960)
Sinclair Oil & Gas Co.	144,714	47.39	20,303	46.96	2,502	63.64	1/27/56	G- 9291	Hearings in Recess
Continental Oil Co.	139,782	49.11	25,076	48.95	1,705	64.64	1/27/56	G-16966	Awaiting Examiner's Decision
Union Oil Co. of California	125,521	50.66	23,966	50.84	1,952	65.78	7/24/56	G-10783	Pending Investigation
Tidewater Oil Co.	119,999	52.14	21,813	52.56	5,001	68.70	1/27/56	G-13310	Settled June 15, 1962
The California Co.	115,278	53.56	24,785	54.52	3,483	70.73	7/24/56	G-10784	Pending Investigation
Union Texas Natural Gas Corp.[7]	105,657	54.86	21,922	56.25	807	71.20	12/ 7/56	G-11563	Settled June 21, 1961
The Ohio Oil Co.	100,666	56.11	13,642	57.33	1,255	71.94	2/29/60	R160-92	Settled June 28, 1962
Amerada Petroleum Corp.	44,986	56.66	6,088	57.81	945	72.49	6/ 8/59	G-18634	Awaiting Commission's Decision
Arkansas Fuel Oil Corp.	23,149	56.95	3,356	58.08	— [5]	72.49	5/18/55	G- 8921	Awaiting Examiner's Decision
Hunt Oil Co.	22,048	57.22	4,054	58.40	1,767	73.52	5/17/56	G-10414	Awaiting Commission's Decision
Sohio Petroleum Co.	19,333	57.46	3,674	58.69	2,441	74.95	4/28/59	G-18355	Awaiting Examiner's Decision
24 Company Total	4,657,654		$ 742,650		$128,357[1]				
Industry Total	8,106,413		$1,265,381		$171,265[1]				

[1] Includes $3,739,655 suspended but not officially listed as suspended as of 12/31/61 due to consolidation in Docket Nos. G-1148, et al., and dismissed thereof in order of September 28, 1960.

[2] Includes Humble Oil & Refining Co. and the Carter Oil Co.

[3] Includes Gulf Oil Corp. and Warren Petroleum Corp.

[4] Includes Cities Service Co., Cities Service Oil Co., Cities Service Gas Producing Co., Cities Service Producing Co., and Cities Service Petroleum Co.

[5] Arkansas Fuel Oil Corp.'s Section 4(e) increases pending as of 12/31/61 are included with Cities Service Co.

[6] Includes Socony Mobil Oil Co., Inc., General Petroleum Corp. and Mobil Producing Co.

[7] Formerly Union Oil & Gas Corp. of Louisiana.

SOURCE: Federal Power Commission, *Direct Sales by Producers of Natural Gas to Interstate Natural Gas Pipeline Companies, 1960;* Federal Power Commission Records.

APPENDIX B

Phillips Petroleum Company Section 4(e) Rate Suspension Proceedings Not Consolidated with Docket Nos. G-1148 et al. and Pending as of December 31, 1961

Purchaser	Rate Schedule Number	Section 4(e) Docket Number	Annual Amount Suspended	Effective Subject to Refund
Arkansas Louisiana Gas Co.	31	G-16113	$ 2,359	2/26/59
Cities Service Gas Co.	257, 298, 321	G-20339	1,527[1]	5/23/60
Colorado Interstate Gas Co.	10, 57, 66	G-18215	27,880[2]	9/18/59
Colorado Interstate Gas Co.	21	G-11622	146,897	6/ 1/57
Colorado Interstate Gas Co.	21	G-20561	151,134	6/ 7/60
Colorado Interstate Gas Co.	240	G-17783	428	7/22/59
Consolidated Gas Utilities Corp.	19	G-12460	63,275	10/12/57
Consolidated Gas Utilities Corp.	19	G-14930	93,522	10/12/58
Consolidated Gas Utilities Corp.	19	G-18273	61,302	10/12/59
Consolidated Gas Utilities Corp.	19	RI60-394	288,598	11/16/60
El Paso Natural Gas Co.	7, 9, 32, 33, 64, 243	G-14115	3,637,284	6/ 1/58
El Paso Natural Gas Co.	7, 9, 32, 64, 243	G-18417	2,212,624	1/ 1/60
El Paso Natural Gas Co.	7, 9, 64, 243	G-20404	1,090,103	6/ 2/60
El Paso Natural Gas Co.	10	G-13734	138,052	5/14/58
El Paso Natural Gas Co.	10, 57, 66	G-18215	—— [2]	9/18/59
El Paso Natural Gas Co.	10, 47, 66, 151, 260, 315, 338	G-20405	137,381	6/ 1/60
El Paso Natural Gas Co.	32, 33, 40, 65, 256, 274	G-20403	3,385,616	6/ 1/60
El Paso Natural Gas Co.	33	G-18418	354,443	1/ 1/60
El Paso Natural Gas Co.	66	G-15315	1,751	12/ 1/58
El Paso Natural Gas Co.	256	G-14006	66	6/ 1/58
El Paso Natural Gas Co.	256	G-15314	145	12/ 1/58
El Paso Natural Gas Co.	256	G-18206	960	9/13/59
El Paso Natural Gas Co.	309	G-18207	830	9/13/59
El Paso Natural Gas Co.	309	G-20523	2,184	6/ 7/60
El Paso Natural Gas Co.	358	RI60-2	4,101	6/ 7/60
El Paso Natural Gas Co.	359	RI60-15	127,609	6/14/60
El Paso Natural Gas Co.	359	RI61-30	25,795	1/ 8/61
El Paso Natural Gas Co.	363	G-20417	134,335	6/ 1/60
El Paso Natural Gas Co.	279	G-16713	34,657	3/25/59

Phillips Petroleum Company Section 4(e) Rate Suspension Proceedings Not Consolidated with Docket Nos. G-1148 et al. and Pending as of December 31, 1961

Purchaser	Rate Schedule Number	Section 4(e) Docket Number	Annual Amount Suspended	Effective Subject to Refund
Kansas-Nebraska Natural Gas Co.	302	G-16311	$ 37	3/ 1/59
Kansas-Nebraska Natural Gas Co.	302	G-19474	24	3/ 1/60
Kansas-Nebraska Natural Gas Co.	302	RI61-64	15	3/ 1/61
Kansas-Nebraska Natural Gas Co.	247	RI60-93	355	7/ 6/60
Kerr-McGee Oil Industries	183, 288	G-20603	972	6/ 9/60
Kerr-McGee Oil Industries	183, 288	RI60-475	381	7/12/60
Kerr-McGee Oil Industries	183, 288	RI61-332	205	6/21/61
La-Tex Petroleum Products Corp.	218, 246	G-16600	181,125[3]	4/ 1/59
Lone Star Gas Co.	324	RI60-201	2,494	8/25/60
Michigan, Wisconsin Pipe Line Co.	4	G-13069	669,305	2/15/58
Michigan, Wisconsin Pipe Line Co.	4	G-19032	1,610,504	1/ 1/60
Michigan, Wisconsin Pipe Line Co.	4	RI60-349	1,634,525	3/ 7/61
Mississippi River Fuel Corp.	22	G-12283	142	9/ 3/57
Mississippi River Fuel Corp.	22	RI60-257	353	9/21/60
Natural Gas Pipeline Co. of America	257	G-11723	240	6/24/57
Natural Gas Pipeline Co. of America	257	G-14258	177	6/23/58
Natural Gas Pipeline Co. of America	257, 298	G-17429	478	6/23/59
Natural Gas Pipeline Co. of America	257, 298, 321	G-20339	—[1]	5/23/60
Natural Gas Pipeline Co. of America	257, 298	RI61-314	579	6/23/61
Natural Gas Pipeline Co. of America	292, 307	G-18272	122	10/10/59
Natural Gas Pipeline Co. of America	292, 307	RI61-456	217	10/10/61
Natural Gas Pipeline Co. of America	298	G-14555	323	7/28/58
Natural Gas Pipeline Co. of America	307	G-15013	52	10/10/58
Natural Gas Pipeline Co. of America	326	RI61-284	16,825	5/27/61
Natural Gas Pipeline Co. of America	332	G-17878	499	8/21/59
Natural Gas Pipeline Co. of America	332	RI60-169	462	8/21/60
Natural Gas Pipeline Co. of America	332	RI61-362	464	8/21/61
Natural Gas Pipeline Co. of America	41	G-12685	22,813	11/ 9/57
Northern Natural Gas Co.	24	G-11641	236,867	6/ 1/57
Northern Natural Gas Co.	24	G-17295	72,528	6/ 1/59
Northern Natural Gas Co.	176	G-15088	44	10/24/58

Phillips Petroleum Company Section 4(e) Rate Suspension Proceedings Not Consolidated with Docket Nos. G-1148 et al. and Pending as of December 31, 1961

Purchaser	Rate Schedule Number	Section 4(e) Docket Number	Annual Amount Suspended	Effective Subject to Refund
Northern Natural Gas Co.	252	G-14009	$ 9,132	6/ 1/58
Northern Natural Gas Co.	262	G-16178	84,816	3/ 1/59
Northern Natural Gas Co.	262	G-19473	89,943	3/ 1/60
Northern Natural Gas Co.	262	RI60-226	802,596	10/ 1/60
Northern Natural Gas Co.	58	RI60-277	978	10/ 1/60
Northern Natural Gas Co.	336	RI62-240	2,131	——
Panhandle Eastern Pipe Line Co.	5	G-16112	384,006	9/ 2/58
Panhandle Eastern Pipe Line Co.	5	G-19845	2,717,526	3/26/60
Panhandle Eastern Pipe Line Co.	5	G-20550	——	3/26/60
Panhandle Eastern Pipe Line Co.	290	RI62-16	618	——
Permian Basin Pipeline Co.	18	G-11849	298,560	7/ 8/57
Permian Basin Pipeline Co.	18	G-17071	101,963	5/ 1/59
Shamrock Oil & Gas Corp.	83	RI61-497	3,421	10/21/61
Southern Natural Gas Co.	219	G-16083	364,702	2/ 1/59
Southern Natural Gas Co.	219	G-17920	85,096	8/ 9/59
Southern Natural Gas Co.	299, 300	G-17156	83,233	5/13/59
Southern Natural Gas Co.	301	G-17267	28,398	5/18/59
Tennessee Gas Transmission Co.	3, 30, 43	G-20542	12,722	6/ 1/60
Tennessee Gas Transmission Co.	20	G-20543	5,698	6/ 1/60
Tennessee Gas Transmission Co.	29	G-17138	9,078	6/ 1/59
Tennessee Gas Transmission Co.	36, 209, 231	G-17280	64,776	6/ 1/59
Tennessee Gas Transmission Co.	39	G-17139	3,025	6/ 1/59
Tennessee Gas Transmission Co.	200	G-17277	3,604	6/ 1/59
Tennessee Gas Transmission Co.	218, 246	G-16600	—— [3]	4/ 1/59
Tennessee Gas Transmission Co.	218	G-18414	14,687	10/ 7/59
Texas Gas Pipe Line Corp.	145	G-19950	35,151	4/ 2/60
Texas Gas Transmission Corp.	202	G-11991	34,082	7/15/57
Transcontinental Gas Pipeline Corp.	149, 220	G-17740	85,940	7/ 9/59

Phillips Petroleum Company Section 4(e) Rate Suspension Proceedings Not Consolidated with Docket Nos. G-1148 et al. and Pending as of December 31, 1961

Purchaser	Rate Schedule Number	Section 4(e) Docket Number	Annual Amount Suspended	Effective Subject to Refund
United Fuel Gas Co.	273	G-14260	$ 61,902	5/16/58
United Fuel Gas Co.	273	G-16712	43,435	4/ 1/59
United Fuel Gas Co.	273	G-20013	135,337	4/ 5/60
West Lake Natural Gasoline Co.	316	G-20349	3,092	1/23/60
West Lake Natural Gasoline Co.	316	RI60-390	3,149	6/24/60
Total			$22,150,782	

[1] Annual amount suspended of $1,527 in Docket No. G-20339 includes purchases by both Cities Service Gas Co. and Natural Gas Pipeline Company of America.

[2] Annual amount suspended of $27,880 in Docket No. G-18215 includes purchases by both Colorado Interstate Gas Co. and El Paso Natural Gas Co.

[3] Annual amount suspended of $181,125 in Docket No. G-16600 includes purchases by both La-Tex Petroleum Products Corp. and Tennessee Gas Transmission Co.

SOURCE: Federal Power Commission records.

APPENDIX C

Comparison of Phillips' Prices Under "New" Rate Schedules,* Not Included in Docket Nos. G-1148 et al., With Area Rate Standards Set Forth in Statement of General Policy No. 61-1 as Amended

Rate Schedule Number	Purchaser	Area Designation	F.P.C. Area Price		Filed Rate as of 12/31/61	Latest Indicated Annual Volume[1] (Mcf)	Annual Revenue at 12/31/61 Filed Rate	Latest § 4(e) Docket Number
			Initial Rates	Increased Rates				
			(14.65 Psia)					
273	United Fuel Gas	So. La.	20.72¢	15.36¢	22.31¢	14,113,490	$3,148,720	G-20013
274	El Paso Natural Gas	N. Mex. P.B.	16.00	11.00	15.56	135,901	21,146	G-20403
275	Wilcox Trend Gathering System	R.R. #2	18.00	14.00	14.37	9,381[2]	1,348	
276	Louisiana Nevada Transit	No. La.	18.28	15.36	12.68	51,542	6,536	
277	Colorado Interstate Gas	Kansas	16.00	11.00	12.09	20,040	2,423	
278	American Louisiana Pipe Line	So. La.	20.72	15.36	20.96	775,426	162,529	
279	El Paso Natural Gas	Wyoming	15.00	12.70	18.04	4,083,663	736,693	G-16713
281	Texas Eastern Transmission	R.R. #2	18.00	14.00	14.37	35,759	5,139	
282	Warren Petroleum Corp.	R.R. #10	17.00	11.00	5.25	7,919	416	
286	Texas Eastern Transmission	R.R. #6	15.00	14.00	15.00	10,572	1,586	
288	Kerr-McGee Oil Industries	R.R. #10	17.00	11.00	11.55	1,471	170	RI61-332
289	Kansas-Nebraska Natural Gas	Okla. Panhandle	17.00	11.00	16.00	3,078	492	
290	Panhandle Eastern Pipe Line	Okla. Panhandle	17.00	11.00	16.00	76,980	12,317	RI62-16
291	Pioneer Gathering System	R.R. #1	15.00	14.00	10.75	3,588,882	385,805	
292	Natural Gas Pipeline Co. of America	Okla. Panhandle	17.00	11.00	17.00	15,638	2,658	RI61-456
294	Northern Natural Gas	R.R. #10	17.00	11.00	16.50	4,823,512	795,879	
296	Panhandle Eastern Pipe Line	Kansas	16.00	11.00	15.00	28,933	4,340	
297	Cities Service Gas Co.	Okla. Other	15.00	11.00	12.00	99,996[3]	12,000	
298	Natural Gas Pipeline Co. of America	Okla. Panhandle	17.00	11.00	17.00	185,721	31,573	RI61-314
299	Southern Natural Gas	So. La.	20.72	15.36	23.09	5,543,188	1,279,922	G-17156
300	Southern Natural Gas	So. La.	20.72	15.36	23.09	2,314,643	534,451	G-17156
301	Southern Natural Gas	So. La.	20.72	15.36	23.08	1,068,388	246,584	G-17267
302	Kansas-Nebraska Natural Gas	Okla. Panhandle	17.00	11.00	16.60	5,174	859	RI61-64
303	Pacific Northwest Pipeline	Colorado	14.60	12.70	15.60	3,122[2]	487	
304	Arkansas Louisiana Gas	No. La.	18.28	15.36	12.68	90,828	11,517	
305	El Paso Natural Gas	Utah			17.26	1,672,496	288,673	
306	Permian Basin Pipeline	R.R. #8	16.00	11.00	16.00	5,744,135	919,062	
307	Natural Gas Pipeline Co. of America	Okla. Panhandle	17.00	11.00	17.00	31,423	5,342	RI61-456
309	El Paso Natural Gas	R.R. #7-C	16.00	11.00	13.68	64,688	8,849	G-20523
310[4]	Montana-Dakota Utilities	Wyoming	15.00	12.70	7.80	39,219	3,059	
312	Texas Gas Gathering	No. La.	18.28	15.63	14.14	971,432	137,360	
313	Panhandle Eastern Pipeline	Kansas	16.00	11.00	15.00	1,557	234	
314	Panhandle Eastern Pipeline	R.R. #10	17.00	11.00	16.00	14,288	2,286	
315	El Paso Natural Gas	R.R. #7-C	16.00	11.00	17.23	78,950	13,603	G-20405
317	Trunkline Gas	R.R. #3	18.00	14.00	20.00	11,171,470	2,234,294	
318	Trunkline Gas	R.R. #3	18.00	14.00	20.00	9,419,400	1,883,880	

Comparison of Phillips' Prices Under "New" Rate Schedules.* Not Included in Docket Nos. G-1148, et al., With Area Rate Standards Set Forth in Statement of General Policy No. 61-1 as Amended

Rate Schedule Number	Purchaser	Area Designation	F.P.C. Area Price		Filed Rate as of 12/31/61	Latest Indicated Annual Volume[1] (Mcf)	Annual Revenue at 12/31/61 Filed Rate	Latest § 4e Docket Number
			Initial Rates	Increased Rates				
			(14.65 Psia)					
319	United Gas Pipe Line	R.R. #6	15.00¢	14.00¢	13.12¢	7,549	$ 991	
321	Cities Service Gas Co.	Kansas	16.00	11.00	13.00	41,822	5,437	G-20339
322	United Gas Pipe Line	R.R. #4	18.00	14.00	14.61	49,629[2]	7,251	
324	Lone Star Gas	Okla. Other	15.00	11.00	13.30	5,223	695	RI60-201
325	Cities Service Gas Co.	Okla. Other	15.00	11.00	11.00	2,014,922	221,641	
326	Natural Gas Pipeline Co. of America	R.R. #9	14.50	14.50	14.13	1,054,802	149,044	RI61-284
327	Panhandle Eastern Pipeline	Kansas	16.00	11.00	13.00	60,872	7,913	
328	United Gas Pipe Line	R.R. #2	18.00	14.00	12.15	206,378	25,075	
329	Commonwealth Oil Co.	So. La.	20.72	15.36	18.46	10,296,874	1,900,803	
330	Tennessee Gas Transmission	So. La.	20.72	15.36	22.26	1,991,336	443,271	
331	West Texas Gathering	R.R. #8	16.00	11.00	16.00	540,000[3]	86,400	
332	Natural Gas Pipeline Co. of America	Okla. Panhandle	17.00	11.00	17.00	34,403	5,849	RI61-362
336	Northern Natural Gas	Okla. Panhandle	17.00	11.00	15.00	76,536	11,480	RI62-240
337	El Paso Natural Gas	N. Mex. San Juan	12.70	12.70	12.68	35,743	4,532	
338	El Paso Natural Gas	N. Mex. P.B.	16.00	11.00	17.07	411,931	70,317	G-20405
339	Coastal States Gas Producing	R.R. #2	18.00	14.00	10.10	457,482	46,206	
342	Transcontinental Gas Pipe Line	So. La.	20.72	15.36	23.45	763,044[3]	178,934	
344	Lone Star Gas	Okla. Carter Knox	16.80	11.00	16.80	92,992	15,623	
345	New York State Natural Gas	Pennsylvania			26.29	1,961,322	515,632	
346	Kerr-McGee Oil Industries	R.R. #10	17.00	11.00	12.00	729,540	87,545	
347	Texas Gas Transmission	No. La.	18.28	15.36	13.41	106,153	14,235	
348	Texas Gas Transmission	No. La.	18.28	15.36	17.79	12,154	2,162	
349	Texas Gas Transmission	No. La.	18.28	15.36	15.36	280,492	43,084	
351	Michigan-Wisconsin Pipe Line	Okla. Panhandle	17.00	11.00	17.00	488,052	82,969	
352	Coastal Transmission Corp.	R.R. #4	18.00	14.00	16.50	501,790	82,795	
353	Panhandle Eastern Pipeline	Okla. Panhandle R.R. #10	17.00	11.00	16.00	1,699,571	271,931	
354	Southern Natural Gas	So. La.	20.72	15.36	22.67	426,087	96,594	
355	Hope Natural Gas	So. La.	20.72	15.36	22.96	130,257	29,907	
357	United Gas Pipe Line	So. La.	20.72	15.36	22.23	151,378[3]	33,651	
358	El Paso Natural Gas	R.R. #7-C	16.00	11.00	14.70	35,400	5,204	RI60-2
359	El Paso Natural Gas	R.R. #8	16.00	11.00	17.16	1,647,154	282,652	RI61-30
360	United Gas Pipe Line	R.R. #2	18.00	14.00	14.18	811,849	115,120	
361	Northern Natural Gas	Okla. Panhandle	17.00	11.00	15.00	34,642	5,196	
362	Colorado Interstate	Okla. Panhandle	17.00	11.00	15.00	71,974	10,796	
363	El Paso Natural Gas	R.R. #8	16.00	11.00	14.70	1,739,800	255,751	G-20417
364	Transwestern Pipeline	R.R. #10	17.00	11.00	17.00	744,000[3]	126,480	

Comparison of Phillips' Prices Under "New" Rate Schedules,* Not Included in Docket Nos. G-1148, et al., With Area Rate Standards Set Forth in Statement of General Policy No. 61-1 as Amended

Rate Schedule Number	Purchaser	Area Designation	F.P.C. Area Price		Filed Rate as of 12/31/61	Latest Indicated Annual Volume[1] (Mcf)	Annual Revenue at 12/31/61 Filed Rate	Latest § 4e Docket Number
			Initial Rates	Increased Rates				
365	Cities Service Gas Co.	Okla. Panhandle	17.00¢	11.00¢	16.00¢	172,926	$ 27,668	
366	Cities Service Gas Co.	Okla. Panhandle	17.00	11.00	16.00	71,566	11,451	
367	Northern Natural Gas	Okla. Panhandle	17.00	11.00	15.00	35,359	5,304	
368	Transwestern Pipeline	R.R. #8	16.00	11.00	16.00	138,545	22,167	
369	Transwestern Pipeline	R.R. #10	17.00	11.00	17.00	356,808[5]	60,657	
370	Texas Eastern Transmission	No. La.	18.28	15.36	15.41	351,040	54,095	
371[6]	Henderson Trust	R.R. #5	14.50	14.50	11.00	73,250	8,058	
372	Coastal Transmission	So. La.	20.72	15.36	20.72	2,575,275[3]	533,597	
374	Transwestern Pipeline	N. Mex. P.B.	16.00	11.00	16.00	522,000[3]	83,520	
375	Colorado Interstate Gas	Kansas	16.00	11.00	17.00	72,000[3]	12,240	
376	Arkansas Louisiana Gas	Okla. Other	15.00	11.00	11.00	372,000[3]	40,920	
377	Michigan-Wisconsin Pipe Line	R.R. #10	17.00	11.00	12.67	9,000,000[3]	1,140,300	
380[7]	Colorado Interstate Gas	Kansas	16.00	11.00	11.00[7]	720,000[3]	79,200	
382	New York State Natural Gas	Pennsylvania			26.29	1,089,592[3]	286,454	
	Total					111,565,819	$20,511,029	

* The last rate schedule included in Phillips' Exhibit 223 in Docket Nos. G-1148 et al., was Rate Schedule #270. This tabulation includes Rate Schedules #271 through #382, excluding those which are no longer in effect and casinghead and liquids contracts.

[1] Volume shown is full-year deliveries for 1961, unless otherwise noted.

[2] No deliveries in 1961. Volume shown is for 1960.

[3] Volume shown is based on estimated first-month deliveries shown on sample billing statement.

[4] Supersedes Rate Schedule #242.

[5] Annualized 1961 Volume.

[6] Supersedes Rate Schedule #60.

[7] Supersedes Rate Schedule #81. The initial price under Rate Schedule #380 is 11.00 cents which became effective 3/8/62; the current price under this rate schedule is 12.50 cents, which was suspended by the FPC in Docket No. RI 62-400.

Code for Area Designation:

So. La.—South Louisiana
No. La.—North Louisiana
N. Mex. P.B.—New Mexico Permian Basin
R.R.—Texas Railroad Commission District
Okla.—Oklahoma

SOURCE: Phillips Petroleum Company, Form 301 for years ended December 31, 1960 and December 31, 1961.

Phillips Petroleum Company rate schedules, supplements and billing statements on file with the Federal Power Commission.

Federal Power Commission, *Statement of General Policy No. 61-1*, issued September 28, 1960, and amendments thereto.

APPENDIX D

Distribution by Price Class of Average Prices Paid for Natural Gas by Interstate Pipelines in South Louisiana in 1960

Price Class	1960 Purchases Mcf	Per Cent of Total
	(15.025 Psia)	
6.00- 6.99	2,221,736	0.11%
7.00- 7.99	666,642	0.03
8.00- 8.99	23,309,679	1.14
9.00- 9.99	38,811,248	1.90
10.00-10.99	35,714,274	1.75
11.00-11.99	40,272,392	1.97
12.00-12.99	2,677,253	0.13
13.00-13.99	495,768	0.02
14.00-14.99	2,670,530	0.13
15.00-15.99	37,982,695	1.86
16.00-16.99	5,263,682	0.26
17.00-17.99	42,823,701	2.09
18.00-18.99	180,441,826	8.83
19.00-19.99	158,926,371	7.77
20.00-20.99	252,391,713	12.35
21.00-21.99	337,183,253[1]	16.49
22.00-22.99	402,139,026	19.67
23.00-23.99	423,440,530	20.71
24.00-24.99	56,830,783	2.78
Total	2,044,263,102	100.00%
Average Price 20.57¢ Purchases Above 21.25¢	1,128,327,240	55.19%

Source: F.P.C. Form 2 Reports, Year ended December 31, 1960.

[1] 245,916,901 Mcf in this price class sold for more than 21.25 cents, the FPC "new gas" ceiling.

1960 South Louisiana Jurisdictional Sales by 13 Producers at Prices Above 21.25 Cents

(Mcf at 15.025 Psia)

Producer	Total	Estimated Not Subject to Refund[1]
Amerada	4,024,376	99,837
Cities Service	6,661,308	1,042,637
Continental	82,402,402	2,921,393
Gulf	27,100,259	5,646,958
Hunt Oil	8,892,149	26,199
Ohio	7,071,256	0
Phillips	42,697,022	23,950,166
Shell	132,882,136	14,009,648
Sohio	11,926,080	978,865
Sun	34,002,685	18,549,843
Texaco	50,591,625	47,766,413
Tidewater	14,011,377	11,382,513
Union Producing	13,806,581	8,006,985
Total 13 Producers	436,069,256	134,381,457
Total All Producers	1,128,327,240	

Source: F.P.C. Form 2 Reports, Year ended December 31, 1960.

[1] Sales not subject to refund include certain sales which are not identified as to their interstate or intrastate nature; and rate schedules under which no actual collections were made subject to refund.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1962

No. 72

STATE OF WISCONSIN and PUBLIC SERVICE COMMISSION OF WISCONSIN, and PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK, *Petitioners*,

v.

FEDERAL POWER COMMISSION and PHILLIPS PETROLEUM COMPANY, *Respondents*.

No. 73

PEOPLE OF THE STATE OF CALIFORNIA and PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, *Petitioners*,

v.

FEDERAL POWER COMMISSION and PHILLIPS PETROLEUM COMPANY, *Respondents*.

No. 74

LONG ISLAND LIGHTING COMPANY, PHILADELPHIA ELECTRIC COMPANY, and THE UNITED GAS IMPROVEMENT COMPANY, *Petitioners*,

v.

FEDERAL POWER COMMISSION and PHILLIPS PETROLEUM COMPANY, *Respondents*.

On Writs of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

BRIEF FOR RESPONDENT PHILLIPS PETROLEUM COMPANY

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OCTOBER TERM, 1962

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v.

FEDERAL POWER COMMISSION and PHILLIPS PETROLEUM COMPANY, *Respondents.*

On Writs of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

BRIEF FOR RESPONDENT PHILLIPS PETROLEUM COMPANY

OPINIONS BELOW

The opinion of the Court of Appeals (R. 410-430) is reported at 303 F. 2d 380. The opinion and the order of the Federal Power Commission (R. 251-342) is

reported at 24 FPC 537, and the Commission's order denying rehearing (R. 395-404) is reported at 24 FPC 1008. The decision of the Presiding Examiner (reproduced in part in the record, R. 35-217) is reported in full at 24 FPC 590.

JURISDICTION

The jurisdictional requisites are adequately set forth in Petitioners' briefs.

STATUTE INVOLVED

The statute involved is the Natural Gas Act (52 Stat. 821-833, as amended; Title 15 USC §§ 717-717w). The pertinent provisions are printed in Petitioners' briefs in No. 72 (pp. 2-5) and No. 74 (pp. 2-5). Additional provisions of the Natural Gas Act are printed in the Appendix to Petitioner's brief in No. 73.

QUESTIONS PRESENTED

The principal question presented is:

1. May the Federal Power Commission terminate its investigation of the rates of an independent producer under Sections 4(e) and 5(a) of the Natural Gas Act after reviewing the record and finding that (1) test year cost of service substantially exceeded test year revenues (even after allowing for Section 4(e) increases), (2) there is nothing to show that existing rates are unduly discriminatory or preferential, and (3) at the time of decision in 1960, the 1954 test year is not suitable for fixing future rates?

An additional question which is presented only in No. 73 is:

2. May the Federal Power Commission refuse to reject a rate increase based on contractual provisions

which (after a specified increase in the wholesale commodity index) permit a producer to increase its price in proportion to an increase in the resale rates of the pipeline company purchaser, particularly where the Commission considered such provision as constituting nothing more than contractual consent to a rate increase which must be otherwise justified?

STATEMENT

A. The Proceedings Before the Commission

On November 22, 1954, following the decision of this Court in *Phillips Petroleum Company* v. *Wisconsin*, 347 U.S. 672 (1954), the Federal Power Commission (Commission) reinstituted its investigation (which had been initiated originally by the Commission's order of October 28, 1948, R. 17) into the rates and charges of Phillips Petroleum Company (Phillips) pursuant to Section 5(a) of the Natural Gas Act (Act). The purpose of the investigation was to determine whether any of Phillips' existing rates were unjust or unreasonable and, if so, to fix just and reasonable rates for the future.[1] This general investigation was docketed under the style "In the Matter of Phillips Petroleum Company, Docket No. G-1148".

On August 6, 1954, the Commission issued its order No. 174 which, together with subsequent orders, established rules and regulations under which independent producers of natural gas (as defined in such orders) were required to file rate schedules and certificate ap-

[1] Both the order issued October 28, 1948, (R. 20), the original order establishing the Section 5(a) proceeding and the order issued November 22, 1954, reopening the Section 5(a) investigation (R. 409) specifically provided for the fixing of rates only in the event existing rates were found to be unjust or unreasonable.

plications (18 CFR Secs. 154.91-154.103, 157.23-157.31). Pursuant to these regulations Phillips filed rate schedules and certificate applications covering its sales being made subject to the jurisdiction of the Commission. From time to time thereafter, Phillips also filed, pursuant to Section 4 of the Act and the Commission's regulations thereunder, changes in rates to permit it to collect increases provided in its contracts.

On May 28, 1956, the Commission issued its order providing for the commencement on June 26, 1956, of *hearings in* the general investigation (Docket No. G-1148). In the same order, the Commission consolidated eight rate increase proceedings designated as Docket Nos. G-3175, G-4333, G-6621, G-7773, G-8623, G-8695, G-8883 and G-10359, all of which covered rate increases which had been filed by Phillips and suspended by the Commission pursuant to Section 4(e) of the Act (R. 21). Subsequent to the commencement of hearings, the Commission consolidated with Docket No. G-1148 four additional Section 4(e) rate increases designated as Docket Nos. G-10793, G-10883, G-11125, and G-11217 (R. 27). The consolidated proceedings as so constituted included all but two of the rate increases which had been filed by Phillips and suspended by the Commission prior to December 14, 1956, the date of the order of consolidation.[2]

During the course of the hearings in Docket G-1148 and the consolidated Section 4(e) increases and thereafter, Phillips continued to file from time to time fur-

[2] The only two rate increases not consolidated were those involved in Docket Nos. G-11309 and G-11326. The two increases combined totaled less than $10,000 annually. Both increases were later settled and the proceedings terminated prior to the issuance of the Commission's opinion in this proceeding.

ther increases pursuant to Section 4 of the Act. Many of these increases were suspended by the Commission pursuant to Section 4(e) of the Act. The Commission did not act to consolidate any of these later Section 4(e) increases with these proceedings and no party requested that such later increases be made a part of this proceeding. All parties appeared content to allow the later Section 4(e) increases to be considered in future proceedings. Consequently, the record in this proceeding does not include any evidence with respect to revenues resulting from or costs related to such later increases. Except in one minor case (Docket G-8623) involving an annual increase of $21,234 (R. 325), all of these consolidated Section 4(e) increases had at the time of the Commission's decision in this proceeding been superseded by one or more of the other rate increase filings mentioned above and which had been suspended and are still pending before the Commission in other dockets.[3]

Hearings on the consolidated Section 4(e) and Section 5(a) proceedings commenced as ordered on June 26, 1956, and terminated on December 18, 1957. Phillips, the Commission Staff and thirty-one Intervenors actively participated in the hearings (R. 252). Following the close of hearings, the Presiding Examiner issued a lengthy decision (reproduced in part, R. 35-217, reported in full, 24 FPC 590). Numerous exceptions to his decision were then filed with the Commission. On September 28, 1960, the Commission issued a comprehensive opinion reviewing and passing upon the issues presented and allowing and disallowing exceptions to the Examiner's decision (R. 251-342). On

[3] The increase in Docket No. G-8623 has since been superseded by a later filing (not suspended by the Commission).

November 25, 1960, the Commission issued its order passing upon applications for rehearing filed by various Intervenors, amending in part its previous opinion and order and otherwise denying the applications for rehearing (R. 395-404).

B. The Opinion of the Commission

The record before the Commission dealt solely with the rates of Phillips. Nevertheless, the opinion of the Commission in part dealt with matters unrelated to this particular record and involving the general philosophy of principles to be followed in the regulation of independent producers. With respect to such other matters, the Commission first considered at some length the problems which it faced in the regulation of independent producers (R. 256-269). The Commission approached this discussion with the observation:

> "Experience of the Commission in this case, as well as in many other producer rate cases during the last five years, has shown, beyond any doubt, that the traditional original cost, prudent investment rate base method of regulating utilities is not a sensible, or even a workable method of fixing the rates of independent producers of natural gas. The fact that, in this case, we can, by making numerous arbitrary allocations and estimates, arrive at a calculated unit cost of gas does not prove to anyone's satisfaction, including ours, that we have thus solved the problem of fixing prices for natural gas sold by independent producers. We recognize that the use of this method for regulating utilities provides only some possible aid toward solving, but not the answer to, the problem of fixing producers' rates." (R. 256-257)

After reviewing the various problems and difficulties involved, the Commission determined that " . . . the

better method would be to establish fair prices for the gas itself and not for each individual producer". The Commission then announced that it was inaugurating a different method of regulating independent producers to be employed in future proceedings and that, simultaneously with but separate and apart from this proceeding, it was "promulgating a policy statement setting forth rate guidance levels for various producing areas of the country" (R. 266). This separate policy statement was issued by a separate document (not docketed as a part of this proceeding) designated as Statement of General Policy No. 61-1 (R. 343).

The Commission recognized that neither area rates nor the guideline rates announced in the Statement of General Policy were available as a basis for decision in this case. *The Statement of General Policy, as such, is not an issue here, since the record dealt only with Phillips' revenues, costs and rates and there is no evidence relating to that Statement.* On the basis of the record made, the Commission therefore undertook to decide this proceeding by determining a cost of service for Phillips and comparing that cost of service with contract revenues (R. 269-272). By far the greater portion of the Commission's opinion dealt solely with Phillips, was based upon evidence which applied only to Phillips, and in substance constituted an application by the Commission to Phillips' rates of cost principles of the kind referred to in *City of Detroit* v. *Federal Power Commission*, 230 F. 2d 810 (D.C. Cir. 1956), cert. denied 352 U.S. 829.

The determination of a cost of service for Phillips necessarily required the Commission to resolve many different subsidiary questions, such as the method to be used for allocation of exploration costs between gas

and oil (R. 269-306).[4] None of those subsidiary questions are at issue here. In making its determination the Commission approved and adopted the Examiner's finding that the calendar year 1954, with adjustments for certain known increases in costs and increases in revenues through 1956, constituted a proper test year (R. 272). A "test year", as used by the Commission, "involves the use of the statistics of an actual period of twelve months with an estimate of expected sales and expenses for some months into the future. It is sought by this method to develop a statement of costs and revenues for a normal year from which a just and reasonable rate may be derived for future periods." *Michigan Wisconsin Pipe Line Co.* v. *Federal Power Commission*, 263 F. 2d 553, 555 (6th Cir. 1959). *None of the parties objected to 1954 as the test year.* Some parties objected to some of the adjustments and some parties sought trial calculations for additional years, but the use of 1954 cost data for test year purposes was accepted by all parties. Acting on the basis of this test year, the Commission determined that Phillips' cost of service was $55,548,054 (R. 322), modified on rehearing to $54,525,315 (R. 401),[5] compared to test

[4] We do not here intend to indicate our agreement with the cost of service as determined by the Commission. From the viewpoint of Phillips, the cost of service as determined by the Commission is far too low, as the result of numerous errors which we believe were made by the Examiner and the Commission. Because the Commission has not attempted to formulate rates based on that cost of service, there has not yet been any occasion for Phillips to raise any issue with respect to the amount of the cost of service. For the purposes of this proceeding, it is sufficient that the cost of service is at least as high as that determined by the Commission.

[5] Neither of the amounts stated include the additional royalties, taxes and purchase costs which the Commission found would result if Phillips' rates were increased to produce revenues equal to its

year jurisdictional revenues of $45,568,291 (R. 326). The test year revenues as stated included the consolidated Section 4(e) increases, thus leaving a deficiency of approximately $9,000,000 annually between cost of service and contract revenues (R. 212).

The determination of a cost of service was of course merely a step, albeit a major one, in the decisional process. As stated by the Commission:

> "The present proceeding involves an investigation of Phillips' rates on the basis of a record including evidence on the alternate test years 1954 and 1956 of which we chose 1954 in accordance with the decision of the examiner. From our knowledge of the industry, it is clear enough that costs and prices of gas in the field have greatly increased since that time. For instance, we have suspended approximately 95 rate changes filed by Phillips subsequent to the hearing in these proceedings. Some of its more recent filings involve substantial increases. Therefore we do not deem it appropriate to prescribe or require that Phillips file rates for the future based upon the present record. In fact, if this order provided for rates for the future effective in 1960 but based on the test year 1954, it might easily occur that the rates approved here would be lower than those approved in some of Phillips' suspension proceedings now before us. The consequence of this would be that Phillips would be required to decrease its rates in 1960 based upon an earlier test year, a result without reason or justice.
>
> "As a result we shall terminate the rate investigation proceedings in Docket No. G-1148 under

---

cost of service (R. 322, Footnote 41). The Commission held that these added costs would properly be a part of Phillips' cost of service. Addition of such costs would raise the average cost of service from 11.1009¢ per Mcf to approximately 12.16¢ per Mcf.

Section 5(a). Phillips' customers will not be substantially injured, for Phillips' rate filings have been subject to our continuing surveillance and many large increases filed by it have been suspended under Section 4(e) of the Act and are currently the subject of proceedings before us. Furthermore, there is nothing to show that Phillips' contracts relating to Phillips' diverse conditions of sale are unduly discriminatory or preferential. Additionally its customers and consumers will receive the protection of our area pricing standards announced at this time. Phillips will not be injured, for we are thus leaving in effect its contract structure; it has had the privilege of filing increased rates and has done so in substantial amounts as already noted.

"Our approach must be similar with respect to the twelve Section 4(e) proceedings consolidated herewith. Except in one minor case all of these proceedings involve rates which have become effective after the test year, but have been superseded by other rates suspended by us in other proceedings. They must be considered in the light of the record in this case which is based on the cost of service method of regulation, but our conclusions here should not bind future determinations of Phillips' rates either in Section 4(e) proceedings or rate investigations under Section 5(a). The record in this proceeding indicates that these rates have produced revenues less than Phillips' cost of service during the periods that they were in effect. The cost of service determined by us of $55,548,054 or 11.309 cents per Mcf is substantially in excess of Phillips' applicable jurisdictional revenues of $45,568,291.

"Although there is considerable diversity among the rates, there is nothing in the record to show that these past rates reflecting the different conditions of sale are unduly discriminatory or preferential. To allocate costs to each of them would

require reopening the proceedings and the introduction of elaborate evidence. Little would be accomplished by way of adjusting them in any case since neither Phillips nor this Commission have authority under the Act to increase any of them retroactively above the filed level. On our part we would like to disturb area rate patterns as little as possible, particularly on a retroactive basis, having in mind the involved business arrangements that have arisen between the producers and their customers as the industry has developed. We thus find no purpose in continuing the Section 4(e) proceedings and will order that they be terminated with two exceptions discussed below." (R. 324-326) (Footnotes omitted)

Applications for rehearing were filed by some of the parties. In their applications none of these parties objected to the Commission's findings that cost of service exceeded revenues and that Phillips' rates are not unduly discriminatory or preferential. These parties did complain of the dismissal of the proceedings without fixing rates and some requested that the proceedings be reopened. In its "Order Denying Applications for Rehearing, Amending Opinion and Rejecting Application for Rehearing" (R. 395-404), the Commission restated its reasons for terminating the proceedings:

"As we stated in our opinion, on the basis of the record and the test year 1954, we cannot reach a decision on cost of service applicable to the years after the issuance of our opinion and order. The Eastern Seaboard Companies argue that we should grant rehearing, consolidate all of Phillips' Section 4(e) proceedings and direct Phillips to submit a 1959 cost of service determination based on Opinion No. 338 as well as revised rate schedules designed to return its current costs. This, of course, would require reopening the record and

the submission of completely new evidence. For the future it is our judgment that the interest of consumers and the exigencies of regulation will be better served in rate proceedings brought on an area basis rather than on an individual company basis. Therefore, we do not think it in the public interest to reopen these proceedings, to determine a cost of service on the basis of completely new evidence to attempt to determine rates on the basis of Phillips' individual cost of service.

"The basis of our decision to terminate the dozen Section 4(e) dockets was that the rates filed in those dockets produced less revenues than the cost of service determined in our opinion. The fact that some of these rates are in excess of the average cost of service determined by us is immaterial. Phillips' rates would normally vary greatly because the sales are made at widely separated points and under different conditions, and there is nothing to show that these rates are discriminatory or preferential. In our judgment there is little or nothing to be gained for the consumer by continuing a complicated proceeding so as to determine just and reasonable rates for Phillips when it is already known that Phillips was not earning its whole cost of service. To conclude, the attempt here to regulate Phillips' rates on an individual company basis has proved cumbersome and inexact. It has demonstrated however, that there is no public interest in continuing the Section 4(e) proceedings, which are largely concerned with past periods. Furthermore, because of the lapse of time, the 1954 cost of service determined by us is not appropriate for the future. The more recent rate increases filed with us have been suspended under Section 4(e), and they will be subject to the new area methods of regulation discussed in our Policy Statement. In this way we can proceed to a more effective and expeditious regulation of the producer sales." (R. 396-398)

C. The Decision of the Court of Appeals

Petitions for review of the Commission's opinion and order were filed in the United States Court of Appeals for the District of Columbia Circuit by the State of Wisconsin and Public Service Commission of Wisconsin (Wisconsin), the State of California (California) and by Long Island Lighting Company, Philadelphia Electric Company and The United Gas Improvement Company (the Eastern Seaboard Companies). The Public Service Commission of the State of New York (New York) did not file a petition for review but was permitted to intervene in the proceedings in the Court of Appeals.

With respect to the Section 4(e) increases, the Court held that the Commission's findings that cost exceeded revenue, and that the rates were not unduly discriminatory or preferential, justified the termination of those proceedings. The Court specifically held that under the circumstances the Commission was not required to make intermediate (and in effect pointless) findings as to whether the individual 4(e) rates were just and reasonable during the period they were in effect (R. 418-421). The Court also sustained the Commission's termination of the Section 5(a) investigation upon the basis of the record before it. The Court also held that the Commission, being unable to fix rates for the future on the basis of this record, was authorized in its discretion to initiate area proceedings as a basis for fixing rates for the future.

After so holding, the Court then discussed the interim rate procedure set forth in the Commission's Statement of General Policy No. 61-1 pending the fixing of future rates in an area rate proceeding. With respect to this latter point, in approving the Commission's right to establish such a policy, the Court made

it plain that the rates set forth therein were merely guideline rates and were not necessarily just and reasonable rates, as was made plain by the Commission when it stated in its Statement of General Policy as follows (R. 416):

> " 'These price levels, as announced by Appendix A attached to this statement, are for the purpose of guidance and initial action by the Commission and their use will not deprive any party of substantive rights or fix the ultimate justness and reasonableness of any rate level.' "

and as stated by the Commission in its Opinion No. 338 with respect to the rates set forth in its Statement of General Policy No. 61-1 (R. 266):

> "This schedule of prices is only for guidance and does not constitute any determination of just and reasonable rates and will not foreclose any person from justifying a particular rate in any area."

With one judge dissenting, the Court affirmed the Commission.

SUMMARY OF ARGUMENT

I.

Petitioners in Nos. 72 and 73 now seek to raise issues which were not raised in their Application for Rehearing to the Commission. This Court is without jurisdiction to consider any objection to the order of the Commission unless such objection was urged before the Commission in the application for rehearing or there is reasonable ground for failure to do so. *Federal Power Commission* v. *Colorado Interstate Gas Co.*, 348 U.S. 492 (1945). Wisconsin and New York, Petitioners in No. 72, now contend that it was error for

the Commission to terminate the Section 5(a) proceedings and contend also that the Section 4(e) rate increases were discriminatory on their face. Neither contention was made in the application for rehearing and no excuse is offered or available for failure to do so. California, Petitioner in No. 73, now contends that the Commission has erred by abandoning cost of service as a basis of regulation and instead relying on the schedule of prices set forth in the Commission's Statement of General Policy No. 61-1. California not only did not raise these issues in its application for rehearing but instead specifically advised the Commission that it would not raise such issues in this proceeding.

In addition, Petitioners in No. 72 have completely disregarded an explicit rule of this Court. In their petition for certiorari, these Petitioners stated only one Question Presented. In their brief, these Petitioners have added a second Question, dealing with the alleged discriminatory nature of the Section 4(e) increases. Paragraph 1(d)(2) of Rule 40 of this Court expressly prohibits the raising of questions in the brief which were not raised in the petition.

II.

The Commission did not err in terminating the Section 5(a) proceedings without fixing rates for the future. Under the findings made by the Commission, the Commission's only alternatives were either to terminate the proceedings or to reopen the proceedings for the reception of "completely new evidence". Petitioners do not object to the Commission's decision not to take action on this record; Petitioners object only to the Commission's decision to receive additional evidence in a different proceeding instead of reopening this record.

Petitioners seek administrative relief rather than judicial review. What Petitioners demand is that this Court act as a super-administrative body and direct the Commission in the conduct of its administrative functions. Petitioners are not entitled to judicial review because they have shown no injury on this record. One of the main targets of Petitioners' objections—Statement of General Policy No. 61-1 and accompanying price schedules—was not used in any way to support the findings of the Commission, since the Commission's findings were based solely on Phillips' costs and revenues as shown in this record. The statutory power "to affirm, modify, or set aside" orders of the Federal Power Commission does not authorize the Court "to exercise an essentially administrative function", *Federal Power Commission* v. *Idaho Power Co.*, 344 U.S. 17, 21 (1952). Administrative bodies are and must be allowed to control their own affairs free of court interference. *Federal Communications Commission* v. *Pottsville Broadcasting Company*, 309 U.S. 134 (1940).

Since the Commission did not find Phillips' rates to be "unjust, unreasonable, unduly discriminatory or preferential", the Commission was not authorized to fix rates for the future in this proceeding. Under Section 5(a) of the Act, such a finding is a condition precedent to the authority of the Commission to fix rates for the future. *Federal Power Commission* v. *Sierra Pacific Power Company*, 350 U.S. 348, 353 (1956). After a careful review of the entire record, the Commission did not make such findings. Except for the unsupported contention—made here for the first time—that some of the contract rates are discriminatory, Petitioners do not contend that the Commission should have done so. It was therefore entirely proper

for the Commission to terminate the Section 5(a) proceedings without fixing rates for the future.

The contention that the Commission erred in permitting the contract rates to stand, without finding such rates to be just and reasonable, is wholly without substance. This Court in *United Gas Pipe Line Co. v. Mobile Gas Service Corp.*, 350 U.S. 332 (1956) made it clear that the power and authority of the Commission over rates is simply the power to review rates and contracts, made in the first instance by natural gas companies, and to set aside and modify only those rates or contracts which it finds after hearing, to be unjust, unreasonable, unduly discriminatory or preferential. Any rate or contract which the Commission after hearing does not find to be unlawful stands on its own feet and is not dependent upon any finding by the Commission that it is just and reasonable. The Act does not require any such affirmative finding and no court has so interpreted the Act. On the contrary, this Court's decision in *Federal Power Commission v. Sierra Pacific Power Company*, 350 U.S. 348 (1956) shows that the Commission may be compelled to allow a contract rate to remain in force even though the Commission does not and could not find such rate to be just and reasonable.

The decision not to reopen this proceeding lay solely within the discretion of the Commission. The Commission found that the present record was not representative of future conditions. Petitioners do not contend that the Commission should have acted on this record. The question of whether a proceeding such as this should be reopened is a matter for the discretion of the Commission, not a matter of law for this Court. *Interstate Commerce Commission v. Jersey City*, 322

U.S. 503, 514-515 (1944); *United States* v. *Pierce Auto Freight Lines*, 327 U.S. 515, 535 (1946); *City of Detroit* v. *Federal Power Commission*, 230 F. 2d 810, 822 (D.C. Cir. 1955), cert. denied 352 U.S. 829. Since the Commission found that any reopening would require "completely new evidence" (R. 397), it clearly was not an abuse of discretion to decide to receive such new evidence in a new proceeding.

III.

The Commission was fully justified in terminating the consolidated Section 4(e) proceedings. The specific bases for terminating such proceedings were the Commission's findings that such rates had not produced revenues in excess of the cost of service and that the evidence did not show that such rates were unduly discriminatory or preferential (R. 325-326, 397). Petitioners do not contend that the evidence would entitle them to refund of any of the revenues collected under the consolidated Section 4(e) rate increases. Furthermore, revenues above the levels of the consolidated Section 4(e) increases which result from later increases are not affected by the termination of the consolidated Section 4(e) proceedings, since these later increases remain subject to pending Section 4(e) proceedings. The Commission's findings are supported by substantial evidence and are therefore binding on the Court. Natural Gas Act, Section 19(b). Further refinements of these findings would serve no useful purpose.

IV.

The Commission properly refused to reject contractual price increases based on so-called "spiral escalation clauses". These contract provisions were not treated by the Commission as automatically en-

titling Phillips to an increase but only as furnishing the contractual consent to an increase. *United Gas Pipe Line Co.* v. *Mobile Gas Service Corp.* 350 U.S. 332 (1956). The increases based on these contractual provisions were allowed because the revenues produced by contract rates were less than the cost of service. Contract provisions permitting price escalations at indefinite times are clearly valid and enforceable. *Texas Gas Transmission Corporation* v. *Shell Oil Company*, 363 U.S. 263 (1960); *Atlantic Refining Co.* v. *Public Service Commission of New York*, 360 U.S. 378, 391 (1959); *Warren Petroleum Corp.* v. *Federal Power Commission*, 282 F. 2d 812 (10th Cir. 1960). These particular contract provisions have themselves been upheld and enforced. *Phillips Petroleum Co.* v. *Federal Power Commission*, 227 F. 2d 470 (10th Cir. 1955), cert. denied sub nom. *Michigan Wisconsin Pipe Line Co.* v. *Phillips Petroleum Co.*, 350 U.S. 1005; *Kerr-McGee Oil Industries, Inc.* v. *Federal Power Commission*, 260 F. 2d 602 (10th Cir. 1958). Here the Commission has acted in accord with Congressional policies and has reviewed these increases on the basis of methods which California espouses and upon findings which California does not challenge.

ARGUMENT

I.

PETITIONERS' BRIEFS IN NOS. 72 AND 73 ATTEMPT TO RAISE ISSUES NOT PROPERLY BEFORE THE COURT

Section 19(b) of the Act (17 USC § 717r(b)) provides:

> "No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission in the application for rehearing unless there is reasonable ground for failure so to do."

In No. 72, Wisconsin and New York not only seek to raise questions not urged in the application for rehearing but, in flagrant violation of the express provisions of Rule 40(1)(d)(2) of this Court, also seek to raise an additional question not presented in the Petition for Certiorari. In No. 73, California now urges as reversible error issues which it specifically told the Commission in its application for rehearing it would not raise. Petitioners do not suggest any reason for having failed to raise these objections in their applications for rehearing, and none is available.

No. 72

Petitioners in No. 72 attempt to present two separate questions (Br. No. 72, p. 5). While stated in terms of whether the Commission may "indefinitely defer" the fixing of rates, the first question which these Petitioners seek to present is whether the Commission properly terminated its investigation of Phillips' rates under Section 5(a) of the Act. Their argument on this point leaves no doubt that it is the Commission's action under Section 5 which they desire to have reviewed (Br. No. 72, pp. 21-43). But the termination of the Section 5(a) investigation was not raised by Wisconsin in its application for rehearing to the Commission, the only application for rehearing which supports the proceedings in No. 72.

New York is in the unusual position of having sought and obtained a review by this Court of the Commission's order without having first met the statutory requirement of a timely application for rehearing to the Commission. New York's application for rehearing was tendered after the expiration of the statutory period and was therefore ineffective to preserve its

right to review (R. 395). Upon its application, however, the Court of Appeals permitted New York to intervene in the proceedings below. Its status as a party in the court below thereby gave New York standing to petition for certiorari. 28 USC § 1254(1); *International Union* v. *Eagle-Picher Co.*, 325 U.S. 335, 338-9 (1945).

But mere standing to petition does not determine the issues which may be reviewed. This Court has specifically held that the matters set forth in the application for rehearing limit not only the parties but the reviewing court as well. *Federal Power Commission* v. *Colorado Interstate Gas Co.*, 348 U.S. 492 (1955). Since New York filed no timely application for rehearing, it must confine itself to those issues raised by its co-petitioner, Wisconsin. Wisconsin elected not to include in its application for rehearing those issues which New York has now prevailed upon Wisconsin to assert.

The Wisconsin application for rehearing is the most detailed of those filed by the various Petitioners (R. 349-362). Even so, it did not object to the termination of the Section 5(a) investigation. Its Point (1) urged the striking of the Commission's "statements as to policies to be followed in regulating the rates of independent producers" (R. 351). Its Points (2) through (11) all related to contentions now abandoned (R. 353-360). Finally, its Point (12) alleged error in the termination of part of the consolidated Section 4(e) proceedings (R. 360). But nowhere in that application is there assertion of error in the Commission's termination of the Section 5(a) proceedings. Nor can such assertion be inferred from the other specifications of error. This Court has held that the application for

rehearing must be sufficiently specific to put the Commission on notice that a particular action of the Commission is being attacked. *Federal Power Commission* v. *Colorado Interstate Gas Co., supra*, 348 U.S. at 498. Absent such notice, the right to review is not preserved.

The second question which Wisconsin and New York now seek to raise relates to the alleged error of the Commission in terminating the Section 4(e) dockets. These Petitioners now assert that the Section 4(e) increases were "discriminatory on their face" (Br. No. 72, p. 5). As noted above, in its application for rehearing Wisconsin objected to the termination of some, but not all, of the Section 4(e) proceedings. At that time Wisconsin complained only that some of the Section 4(e) increases were allowed at levels which exceeded the average cost of service (R. 360-361). Wisconsin was apparently content to leave standing all those Section 4(e) increases in which the increased rate was below the cents per Mcf level stated by the Commission as the "average" cost of service.[6] The contention that the contract rates are discriminatory, which now forms an important part of Petitioners' arguments in No. 72 (Br. pp. 38-43, 45-46), is completely absent. Petitioners' cannot supply this deficiency by merely pointing (Br. No. 72, pp. 40, 45) to assertions that some of the rates exceeded the average cost of service.

[6] Wisconsin's contention that rates should not be allowed above that level was specifically answered by the Commission in its order denying rehearing: "The fact that some of these rates are in excess of the average cost of service determined by us is immaterial. Phillips' rates would normally vary greatly because the sales are made at widely separated points and under different conditions, and there is nothing to show that the rates are discriminatory or preferential." (R. 397)

Aside from statutory requirements, Petitioners' attempt to raise their second question constitutes a complete disregard of an express rule of this Court. The Petition for Certiorari in No. 72 sets forth only one Question Presented (Petition, p. 2). While differing slightly in language, the question stated in the Petition is substantially the same as the first of the questions stated in Petitioners' brief (p. 5). The second question set forth in the brief is wholly new, appearing not at all in the Petition.

Rule 40 specifies the matters to be included in Petitioners' brief. Paragraph 1(d)(2) of that Rule states:

> "The phrasing of the questions presented need not be identical with that set forth in the jurisdictional statement or the petition for certiorari, *but the brief may not raise additional questions or change the substance of the questions already presented in those documents.* Questions not presented according to this paragraph will be disregarded, save as the court, at its option, may notice a plain error not presented."[7]

No. 73

California sets forth six separate questions in its brief in No. 73 (Br. pp. 2-3). Questions (3) and (4) seek to raise issues relating to the alleged abandonment by the Commission of cost of service as a method of regulation and the use by the Commission of the schedule of prices set forth in its Statement of General Policy No. 61-1. Almost half of California's arguments in its brief are devoted to these two questions (Br. No. 73, pp. 35-55).

[7] Unless otherwise indicated, all emphasis in quotations in this brief is supplied.

With respect to these issues, California is now attempting to raise issues which it not only failed to raise in its application for rehearing but which it assured the Commission it would not raise. In its application for rehearing, California stated:

> "California takes no position at this time regarding the opinions expressed by the Commission in Opinion No. 338 under the title 'Regulation of Natural Gas Producers' Prices' (mimeo., pp. 5-12) wherein the Commission announces its conviction that regulation of such prices under the cost of service method is unworkable and productive of ridiculous results and wherein the Commission announces its intention to regulate producer prices hereafter by use of an area pricing method as is more particularly described in the Commission's Statement of General Policy No. 61-1 issued on the same date as it issued its opinion in the instant proceedings. *Because the Commission employed the traditional cost of service method in reaching its findings and conclusions in the instant proceedings* (mimeo., p. 13) *its comments concerning the future course of producer rate regulation are therefore not material here.* California reserves the right, however, to challenge such comments as are contained in that portion of Opinion No. 338 indicated above as well as the Statement of General Policy No. 61-1 in any *future* proceeding wherein the Commission's views therein expressed may be material to its determination of rates under the Natural Gas Act." (R. 363-364)

It is apparent that all of the issues sought to be raised in No. 72 and the two issues mentioned which California seeks to raise in No. 73 are not properly before this Court.

II.

THE COMMISSION PROPERLY TERMINATED THE SECTION 5(a) PROCEEDINGS WITHOUT FIXING RATES FOR THE FUTURE

A. Petitioners Seek Administrative Rather Than Judicial Review

This proceeding is unique in that relief on this record is not one of the principal objectives of Petitioners. Petitioners do not contend that on this record the Commission either could or should have reduced the general level of Phillips' rates.

The Commission found that on the basis of revenues and costs associated with sales for the test year, Phillips' costs exceeded its revenues (R. 326). It found also that the record before it did not permit it to fix rates for the future by declaring existing rates unjust and unreasonable and fixing future rates on the basis of test year costs (R. 271, 324-325). Petitioners do not challenge either of these findings. Petitioners therefore find little purpose in resting upon the record in this proceeding and they do not pretend to confine themselves to it. The great bulk of their arguments are based upon unsupported assertions regarding alleged conditions which, if they exist at all, have occurred either long after the close of this record or in other proceedings. Even when they demand reopening of this proceeding, Petitioners are careful to insist that any reopening must include provision for receipt of additional evidence. None of the Petitioners want further action of the Commission based solely upon this record.

It is thus apparent that what Petitioners seek here is not judicial review but rather a directive from this Court acting as a super-administrative body. Petitioners' concern lies not with what has happened in this

proceeding but with what they desire to happen in future proceedings. Petitioners profess not to attack the concept of area rates; they purport to ask only that the Commission be directed to act in a specific manner until the area rate proceedings have all been completed. Yet it is apparent that, in order to attain their objective, Petitioners must obtain from this Court an administrative directive which lays down for the Commission a pattern of procedure to be rigidly followed, leaving to the Commission some discretion as to the application of court-selected methods but little or no discretion as to choice of methods. Petitioners seem unconcerned by the fact that their own arguments demonstrate that, if the Commission must first apply the Court's concept of regulation, it is doubtful whether the Commission will ever have the time and resources to apply its own.

That Petitioners desire administrative rather than judicial review is forcibly demonstrated by their attacks on the Commission's Statement of General Policy No. 61-1 (R. 343). Substantial parts of Petitioners' briefs are devoted to this attack (No. 72, pp. 29-36; No. 73, pp. 48-55; No. 74, pp. 29-32). Yet Statement of General Policy No. 61-1 and the prices therein stated are not a part of the record in this proceeding. The basis of the Commission's decision to terminate the Phillips proceedings was that the record was not suitable for fixing rates for the future and that Phillips' cost of service exceeded its revenues. The Statement of General Policy rates were not a criterion by which the Commission decided this case. The Commission made no comparison of Phillips' contract rates with those set forth in the Statement of General Policy. Under these circumstances, it can hardly be said that

the Statement of General Policy No. 61-1 is a matter for judicial review on this occasion.

In the context of Petitioners' contentions regarding the proceeding under Section 5(a), judicial review in the traditional sense is impossible here. Petitioners are not entitled to a judgment awarding them some form of monetary relief because they have shown no injury on this record. A mere reversal of the Commission's order would award little or nothing to Petitioners. All that a bare reversal would accomplish would be the preservation of the present docket number. Any reversal must be a hollow victory for Petitioners unless the Court goes further and injects itself deep into administrative affairs by devising and prescribing the Court's own concept of producer regulation.

This Court has held that the statutory power "to affirm, modify, or set aside" orders of the Federal Power Commission does not authorize the Court "to exercise an essentially administrative function". *Federal Power Commission* v. *Idaho Power Co.*, 344 U.S. 17, 21 (1952). It has long been held that administrative agencies are and must be permitted to control their own affairs free of court interference. *Federal Communications Commission* v. *Pottsville Broadcasting Company*, 309 U.S. 134 (1940). The wisdom of the principle that courts and administrative bodies must confine their actions to their own spheres is vividly demonstrated here, where administrative review is all that is sought and judicial review is impossible of accomplishment.

B. The Commission Has Done All That the Natural Gas Act Permitted It to Do on the Basis of This Record

The termination by the Commission of the Section 5(a) investigation was fully in accord with both the language and intent of the Act. Indeed, termination was the only action the Commission could take and the only action authorized by the Commission's findings.

The Commission's power to fix rates under Section 5(a) is conditioned upon a finding that existing rates are unjust or unreasonable. Section 5(a) provides in part:

> "Whenever the Commission, after a hearing had upon its own motion or upon complaint . . . shall find that any rate . . . is *unjust, unreasonable, unduly discriminatory, or preferential*, the Commission shall determine the just and reasonable rate . . . to be thereafter observed and enforced, and shall fix the same by order . . . ."

The Commission's order instituting this investigation followed the language of Section 5(a). That order provided, among other things, that:

> "*If* the Commission shall find, after hearing, that any of Phillips' rates . . . are *unjust, unreasonable, unduly discriminatory or preferential* it shall determine and fix . . . rates . . . to be thereafter observed and enforced" (R. 409).

The critical language in both the statute and the order is the phrase "unjust, unreasonable, unduly discriminatory or preferential". Nothing in the language of the statute or the order requires an express finding that existing rates are just and reasonable. But the negative finding that rates are unjust, unreasonable, unduly discriminatory or preferential is expressly made

a condition precedent to the power of the Commission to fix rates for the future.

This limitation on the Commission's power has been specifically recognized by this Court. In *Federal Power Commission v. Sierra Pacific Power Company*, 350 U.S. 348, 353 (1956), after noting that "the provisions of the Federal Power Act relevant to this question are in all material respects substantially identical to the equivalent provisions of the Natural Gas Act", this Court went on to state:

> "The Commission has undoubted power under § 206(a), to prescribe a change in contract rates whenever it determines such rates to be unlawful. * * *
>
> "The condition precedent to the Commission's exercise of its power under § 206(a) is a finding that the existing rate is 'unjust, unreasonable, unduly discriminatory or preferential'."

Here the Commission did not find Phillips' rates to be unjust or unreasonable. On the basis of its unchallenged finding that costs exceeded revenues, and its finding that contract rates were not unduly discriminatory or preferential, the Commission could have found the existing rates to be unjust or unreasonable only because they were *too low*. Petitioners do not contend that the Commission should have made such a finding. But absent such finding, the statutory condition precedent was not met and the Commission was not authorized to "fix" rates.

Dismissal of the proceedings was therefore the only action which the Commission could take.

C. The Act Does Not Require the Commission to Find Rates to be Just and Reasonable Before Permitting Them to Stand

One of Petitioners' principal contentions is that the Commission erred in permitting existing rates to remain in force without an express finding that such rates were just and reasonable. The Commission's powers under Section 5 are phrased in the negative; before the Commission may act it must find that existing rates are *not* just and reasonable. Neither Section 4 nor Section 5 of the Act requires that existing rates be found to be just and reasonable before they may be permitted to remain in force. On the contrary, the Commission may be obligated to permit rates to remain in effect even though it could not hold such rates to be just and reasonable.

In *Federal Power Commission* v. *Sierra Pacific Power Company*, 350 U.S. 348, 355 (1956), this Court held that, even where contract rates produce less than a fair return, the Commission may not fix different rates unless it can hold the contract rates to be unjust and unreasonable as contrary to the public interest (as distinguished from the private interests of the company). If no such findings can be made, then the contract rates must be left standing. This Court carefully pointed out that the Commission's duty to leave the contract rate in force is not affected by the fact that the Commission could not *impose* so low a rate.

The fundamental principle announced in *Sierra* is that the Commission is not required to determine that a rate is just and reasonable before permitting it to stand. Otherwise, the Commission might be obligated to hold that a rate which produces revenues less than costs is nevertheless just and reasonable. Even if circumstances might be conceived in which such a finding

was permissible, *Sierra* makes it clear that it is not required. In particular, it is not required in circumstances where, as here, no party has suggested that such a finding should have been made.

Petitioners' contention stems from a basic misconception of the purpose and intent of the Act. Petitioners seem to assume that contract rates are unlawful *per se* and that the Act contemplates only rates "fixed" by the Commission. They imply that the Commission has shirked its duty if it merely reviews contract rates and refuses, on the basis of the record before it, to "fix" a different set of rates. The theory of the Act is exactly opposite. In *United Gas Pipe Line Co.* v. *Mobile Gas Service Corp.*, 350 U.S. 332 (1956) this Court said:

> "In construing the Act, we should bear in mind that it evinces no purpose to abrogate private rate contracts as such. To the contrary, by requiring contracts to be filed with the Commission, the Act expressly recognizes that rates to particular customers may be set by individual contracts. * * *
>
> "These sections [Section 4 and Section 5(a)] are simply parts of a single statutory scheme under which all rates are established initially by the natural gas companies, by contract or otherwise, and all rates are subject to being modified by the Commission upon a finding that they are unlawful. * * *
>
> "The powers of the Commission are defined by §§ 4(e) and 5(a). The basic power of the Commission is that given it by § 5(a) to set aside and modify any rate or contract which it determines, after hearing, to be 'unjust, unreasonable, unduly discriminatory, or preferential.' This is neither a 'rate-making' nor a 'rate-changing' procedure. It is simply the power to review rates and contracts made in the first instance by natural gas companies

and, if they are determined to be unlawful, to remedy them." (350 U.S. at 338, 341)[8]

Any rate or contract which the Commission after hearing does not find to be unlawful stands on its own and is not dependent upon any finding by the Commission that it is just and reasonable. The Act does not require any such affirmative finding and no court has so interpreted the Act.

D. The Commission Properly Exercised Its Discretion to Terminate Rather Than to Reopen the Section 5(a) Investigation

The Commission here determined a cost of service for Phillips. It did not attempt to use that cost of service as the basis for future rates for Phillips because it found the record was not suitable for that purpose (R. 324-325, 396-397). Petitioners do not challenge the Commission's finding that the record was unsuitable for the purpose of establishing rates for the future. Rather, they contend that the Commission should have reopened the proceedings and have received additional evidence for that purpose.

All parties thus agree that the Commission was not able or required to fix rates for the future *on the basis of this record*. The only question was whether future

[8] Petitioners emphasize the statement of the Court of Appeals in *Wisconsin* v. *Federal Power Commission*, 205 F. 2d 706, 712 (D.C. Cir. 1953) that "Phillips is a 'natural-gas company' within the meaning of the Natural Gas Act and the Commission should fix the rates at which these sales are made". Aside from the fact that this statement was made prior to this Court's decision in *Mobile*, it cannot be presumed that the Court of Appeals was directing the Commission to ignore the requirement of Section 5(a) that existing rates must *first* be found to be "unjust, unreasonable, unduly discriminatory, or preferential".

rates should be considered in some extension or reopening of this particular proceeding or this proceeding terminated and future rates considered in some new proceeding. The Commission chose the latter alternative. That decision lay well within its discretion.

In view of the Commission's findings that cost exceeded revenues and that existing rates were not unduly discriminatory or preferential (R. 325-326, 397), the only possible direction of any revision of existing rates on the basis of this record was upward. Such a course of action would necessarily require the Commission to resolve two issues which had been contested at great length before the Examiner. One was whether the principles of *Sierra* permitted the Commission on this record to set aside existing contracts because the rates were too low (R. 75-86). The other involved the form of rates which might be ordered (R. 160-196, 323-324).[9]

[9] Petitioners assume the validity of the system of rates proposed by the Examiner. His decision, however, contemplated that the Commission would fix rates not only for existing sales but also for all future sales, including rates for sales not yet made from properties not yet owned (R. 193-196). The Commission has never gone so far even with pipeline companies. Whether such a broad approach would be advisable or even permissible under this Court's decision in *United Gas Pipe Line Co.* v. *Mobile Gas Service Corp.*, 350 U.S. 332 (1956) obviously would present serious issues to be decided. Section 5(a) refers only to existing rates; there is no reference to future rates for future sales. Moreover, the Examiner would have required that rates be increased to some pipelines and reduced to others, without either evidence or consideration of whether the pipelines whose purchase prices were to be increased could afford the increase or what the result would be to Phillips if they could not. At least two of the pipeline purchasers (Northern Natural Gas Co. and Panhandle Eastern Pipe Line Co.) had intervened for the sole purpose of seeing that rates to them were *not* raised above contract levels.

It was obvious to the Commission, however, that attempts to resolve these issues on the basis of the present record would constitute an exercise in futility. The fact that many rates had already been increased by virtue of contract provisions and were already the subject of separate proceedings under Section 4(e) made it unnecessary to reach either of these questions in this proceeding (R. 324-325, 397). These circumstances were in addition to the recognized fact that the test year costs were already out of date (R. 325, 396-397).

Faced with such circumstances, it clearly was within the discretion of the Commission to terminate this proceeding and to provide for beginning anew in a different proceeding. It is obvious from the language of the Commission's opinion (R. 324-325) that the Commission was well aware that, if it were to fix rates to begin in 1960 and continue into the future, it must have more current data. By terminating this proceeding the Commission did not drop or abandon its regulation of Phillips' rates as is contended by Petitioners. It merely determined that another record in another proceeding was the more appropriate place to obtain the more current data. This is a determination that can be made only by the Commission and its decision must stand unless captious. The Commission is not required to act on the basis of a particular record. *Eastern Air Lines, Inc.* v. *C.A.B.*, 294 F. 2d 235, 238 (1961), cert. denied 368 U.S. 927.

Petitioners' assertion that the Commission failed to act in this proceeding is not actually directed toward the Commission's decision not to act on the existing record. Petitioners' real complaint is that the Commission did not *reopen* this proceeding in order to proceed in the fashion which Petitioners desire. The dis-

senting opinion of Judge Fahy likewise qualifies its requirement for present decision by references to action on the present record "supplemented as may be found to be reasonably necessary" (R. 429) and "supplemented as may be needed" (R. 430). As the Commission recognized, and as Petitioners do not deny, any such reopening would require "completely new evidence" (R. 397). In substance, a reopening would constitute a completely new proceeding, whether or not designated by the same docket number. Petitioners are in reality doing no more than asking this Court to direct the Commission to institute a new rate case.[10]

The question of whether or not the proceeding should be reopened is a matter for the discretion of the Commission, not a matter of law for this Court. In *Interstate Commerce Commission* v. *Jersey City*, 322 U.S. 503, 514-515 (1944), this Court said:

> "Administrative consideration of evidence, particularly where the evidence is taken by an examiner, his report submitted to the parties, and a hearing held on their exceptions to it, always

[10] The Commission's reference to "completely new evidence" was far more prophetic than the Commission realized. One of the principal issues in this proceeding was the treatment of exploration costs. All parties then agreed that because the search for oil and gas was conducted jointly, exploration costs could be separated between oil and gas only by means of some arbitrary allocation. The allocation method selected by the Commission attributed approximately 30% of Phillips' total exploration costs to the search for gas (R. 296). Phillips has since learned that it can utilize available geological data to direct its exploratory efforts toward either oil or gas. This permits the great bulk of exploratory expenditures to be assigned directly to gas or oil without the necessity for allocation. Testimony introduced in the Permian Basin Area Rate Proceeding (Docket No. AR61-1, Transcript 160-176) shows that, on this basis, during 1959 and 1960 over 60% of Phillips' exploratory expenditures were directly chargeable to gas.

creates a gap between the time the record is closed and the time the administrative decision is promulgated. This is especially true if the issues are difficult, the evidence intricate, and the consideration of the case deliberate and careful. If upon the coming down of the order litigants might demand rehearings as a matter of law because some new circumstance has arisen, some new trend has been observed, or some new fact discovered, there would be little hope that the administrative process could ever be consummated in an order that would not be subject to reopening. It has been almost a rule of necessity that rehearings were not matters of right, but were pleas to discretion. And likewise it has been considered that the discretion to be invoked was that of the body making the order, and not that of a reviewing body.

"Only once in the history of administrative law has this Court reversed a Commission for refusing to grant a rehearing on the contention that the record was 'stale.' * * *

"The Court, however, promptly restricted that decision to its special facts. * * *."

This Court reaffirmed these statements in *United States* v. *Pierce Auto Freight Lines*, 327 U.S. 515, 535 (1946), with the further caveat: "Only a showing of the clearest abuse of discretion could sustain an exception to that rule." In *City of Detroit* v. *Federal Power Commission*, 230 F. 2d 810, 822 (D.C. Cir., 1955), cert denied 352 U.S. 829, the court said:

"Finally, we agree with the Commission that it was not required to reopen the proceedings. Petitioners sought such reopening to permit proof of increased sales volume. Evidence of such increase was offered in the effort to show that the unit cost of service would be reduced. The parties agree, however, that 1952 was a proper test

year, and the Commission made its calculations on the basis of evidence available as to that year. We find no abuse of discretion in the Commission's refusal to reopen for evidence subsequently available, especially as there is no clear indication that the evidence offered, considered with all factors involved, would likely lead to a different result."

Both *Jersey City* and *City of Detroit* involved the same kind of contentions as are made here—contentions by intervenors that subsequent increases in revenues to the regulated company required a second look by the administrative agency. The effect of the court's decision in both cases was that the validity of the Commission's action was not affected by the identity of the challenger. In *Jersey City*, this Court specifically stated that ". . . we cannot hold that the judgment of the Commission is less final merely because it has been exercised on this occasion for relief of the Company." (322 U.S. at 512)

The factors which led the Commission to decide not to reopen the proceedings make it clear also that the Commission's action here was wholly unlike that in *Minneapolis Gas Company* v. *Federal Power Commission*, 294 F. 2d 212 (D.C. Cir. 1961). There the Commission made no determination; there was nothing on which to rest its discretion. Here the Commission rendered an opinion on the record and made specific findings. It passed upon disputed issues and determined a cost of service. It specifically decided the Section 4(e) proceedings on the basis of that finding (R. 325-326, 397). It decided that such findings did not then justify further action in this Section 5(a) proceeding. In the words of the Circuit Judge who

wrote the opinions in both *Minneapolis* and the court below:

> "This is not a *Minneapolis Gas* situation, in which the Commission did nothing but simply terminated the proceedings without passing upon any of the disputed issues before it." (R. 421) (Footnote omitted)

III.

THE COMMISSION WAS JUSTIFIED IN TERMINATING THE SECTION 4(e) PROCEEDINGS

The basis of the Commission's termination of the consolidated Section 4(e) proceedings was its finding that the cost of service exceeded the revenues produced by the contract rates, including the Section 4(e) increases. The Commission found also that mere diversity of rate levels did not establish that the contract rates were unduly discriminatory or preferential (R. 325-326, 397).[11] None of the parties challenged those findings on rehearing. None of the parties even now dispute the fact that costs as found by the Commission exceeded revenues.

As indicated earlier (*supra*, pp. 20-23), Wisconsin and New York (alone among Petitioners) make a belated charge that the contract rates are discriminatory. They offer no evidence in support of that assertion, other than the mere fact of difference. But in asserting that Phillips' many different contracts result in varying prices and hence discrimination, Petitioners overlook the fact that (as stated by this

[11] The findings that existing rates were not unduly discriminatory were made separately with respect to existing rates under scrutiny in the Sec. 5(a) proceeding (R. 325) and with respect to the Section 4(e) rate increases (R. 326).

Court in *United Gas Pipe Line Co.* v. *Mobile Gas Service Corp.*, 350 U.S. 332, 338 (1956)):

> "'. . . by requiring contracts to be filed with the Commission, the Act expressly recognizes that rates to particular customers may be set by individual contracts. In this respect, the Act is in marked contrast to the Interstate Commerce Act, which in effect precludes private rate agreements by its requirement that the rates to all shippers be uniform, a requirement which made unnecessary any provision for filing contracts.'"

As further noted by this Court, the Act is designed to recognize the need for "individualized arrangements" (350 U.S. at 339).

With the same vehemence that Wisconsin and New York now argue that the Commission should fix rates so as to *eliminate* contract differences, the Eastern Seaboard Companies argued before the Examiner that any system of rates fixed by the Commission must *preserve* contract differences.[12] Thus, even as among Petitioners, mere differences in contract rates did not signify undue discrimination. The Commission resolved that issue by finding that the evidence did not show the contract rates to be unduly discriminatory or preferential. That finding is supported by substantial evidence and is therefore binding on this Court. Natural Gas Act, Section 19(b). Even if the differences in contract prices should constitute dis-

[12] The Examiner described the evidence of the Eastern Seaboard Companies on this point as follows: "[Eastern Seaboard witness] Caplan urged that any general rate adjustment should be accomplished with the least possible disturbance to existing market relationships, and he stressed the importance of preserving existing contract arrangements and existing contract prices to the fullest extent consistent with sound regulatory objectives." (R. 173)

crimination, "It is only when a preference or advantage accorded to one customer over another is *undue* or a difference in service as between them is *unreasonable* that Section 4(b) of the Act comes into play. 'And the courts have always recognized that Congress intended to commit to the Commission the determination, by application of an informed judgment to existing facts, of the existence of forbidden preferences, advantages and discrimination.'" *Michigan Consol. Gas Co. v. Federal Power Commission*, 203 F. 2d 895, 901 (3rd Cir. 1953).

The action which Petitioners desire this Court to take with respect to these Section 4(e) proceedings is by no means clear.[13] Petitioners do not contend they are entitled to refunds. A requirement that refunds be made would only enlarge the deficiency between cost and revenue—a clear case of confiscation. The Commission could not retroactively increase the rates over those filed by Phillips. The only action which the Commission could take is precisely the action which it did take—the dismissal of the Section 4(e) proceedings. The objective of any remand thus becomes so obscure as to become almost mysterious.

The contention is made by Petitioners that the Commission did not determine that the Section 4(e) rates were "just and reasonable". But under the circumstances such a finding would have been meaningless. The Commission found that costs exceeded revenues. To have found such rates "just and reasonable" would have required a finding that rates producing revenues less than costs are nevertheless

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[13] The Eastern Seaboard Companies do not question the dismissal of the Section 4(e) proceedings.

just and reasonable, a finding which was neither requested nor required.

The Court below found no difficulty in rejecting this contention:

> "Whether the Commission should have preceded its ultimate conclusion of no-refund with an intermediate conclusion of justness and reasonableness in the rates at issue, and whether it properly added the termination order to its decisive finding, seem to us to be immaterial queries. The important feature is that the Commission reached and decided the critical substantial issue, rationally and upon detailed findings of basic facts upon an ample record." (R. 420)

The further contention that the dismissal of the Section 4(e) proceedings permits the rates to stand during future periods without specific findings as to justness and reasonableness carries no weight. Petitioners concede that all parties agreed on a test year (Br. No. 72, p. 8), but then attempt to avoid the necessary implications of such admission by asserting that such agreed test year is not useful for future periods. Such argument disregards entirely the purpose and objective of a test year. It has been the common practice of the Commission to use the results of a test year "to develop a statement of costs and revenues for a normal year from which a just and reasonable rate may be derived for future periods." *Michigan Wisconsin Pipe Line Co.* v. *Federal Power Commission*, 263 F. 2d 553, 555 (6th Cir. 1959). In *Panhandle Eastern Pipe Line Company*, 25 FPC 787, 795 (1961), remanded on other grounds, *Panhandle Eastern Pipe Line Company* v. *Federal Power Commission*, 305 F. 2d 763 (D.C. Cir. 1962), the

Commission expressly used a 1954 test period with adjustments for the purpose of testing rates during the period 1954-1958 on the basis that the 1954 test year operations were representative of the later periods.

Petitioners defeat their own argument. Wisconsin and New York cite annual reports to the Commission showing Phillips' revenues during the period 1955-1961 (Br. No. 72, p. 24). This table shows that, *even assuming no increases in cost*, Phillips' revenues did not return its costs until after 1958.[14] This comparison was as readily available to the Commission as to these Petitioners. It undoubtedly was the basis for the Commission's statement: "We do not wish to prejudge those proceedings, but it would appear that on the basis of the present record that Phillips' costs probably exceed its revenues at least up through the year 1958, after which very substantial further rate increases were filed by Phillips." (R. 329)[15]

Petitioners' contentions lose all their substance when it is remembered that the Commission's ter-

[14] Contrary to the assertions of Wisconsin and New York (Br. No. 72, p. 25, Footnote 16, p. 26) the record showed that Phillips' costs were increasing. The Examiner's decision makes clear that the 1954 test year was adjusted by the addition of increases in costs known to have occurred since 1954, and that the 1954 test year *as adjusted* was comparable to the actual results of 1956. Even so, the total deficiency had increased. 24 FPC at 701-702. To compare the 1954 test year, adjusted to 1956, with 1956 costs and proclaim, as Petitioners do, that no increase had occurred since 1954 is to ignore the facts.

[15] Wisconsin and New York complain that this statement is "without record support" (Br. No. 72, p. 11). Their later use of the same data seems to indicate their position that, while Commission references must be limited, Wisconsin's and New York's are unrestricted.

mination of the consolidated Section 4(e) proceedings merely subjected Phillips' rates to other, unconsolidated, Section 4(e) proceedings (R. 3251). Wisconsin and New York say they "would have no complaint if Phillips' revenues had remained constant during the period 1955-1959" (Br. No. 72, p. 45). But all that the present decision approves is that same constant level of revenues. Revenues brought about by the "further rate increases" mentioned by the Commission are subject to pending Section 4(e) proceedings. No reversal of the present order is required to make those rate increases the subject of review by the Commission.

It is apparent that the Commission not only decided the Section 4(e) increases but that it decided them on the basis of findings that costs exceeded revenues and that existing rates were not discriminatory.[18] Those findings are supported by substantial evidence and are therefore binding on the parties and the Court. Natural Gas Act, Section 19(b). Further refinement of those findings would serve no useful purpose.

IV.

THE COMMISSION PROPERLY REFUSED TO DISALLOW CONTRACTUALLY PERMITTED INCREASES, OTHERWISE JUSTIFIED ON THE BASIS OF COST, MERELY BECAUSE THE INCREASES RESULTED FROM SO-CALLED "SPIRAL ESCALATION" CLAUSES

Three of the consolidated Section 4(e) increases considered by the Commission were filed by Phillips under contractual provisions which granted Phillips'

[18] *In R. L. Hawkins and H. L. Hawkins, Jr.*, 28 FPC 747, 748, the Commission stated: "In our Opinion No. 338, Phillips Petroleum Company, issued September 28, 1960, in which we announced our area price policy, we nevertheless made a determination of just and reasonable rates for Phillips on a cost-of-service basis because the evidence had been presented almost entirely on that basis."

an increase in rate whenever (1) the wholesale commodity index had risen by more than a specified number of points, and (2) the purchasing pipeline company had itself received a general rate increase. Upon the happening of both of these conditions, the contracts provided that Phillips' rates should be increased in proportion to the increase received by the pipeline company. The stated purpose of these provisions was protection ". . . from too great burden under the price provisions of this agreement in the event of abnormal inflation . . ." (Br. No. 73, Appendix B)[17]

These contractual provisions were treated by the Examiner and the Commission as doing no more than providing Phillips with contractual authorization to file a rate increase under the principles established in *United Gas Pipe Line Co.* v. *Mobile Gas Service Corp.*, 350 U.S. 332 (1956) (R. 196-208, 326-329). The issue as to the justification for these increases, as distinguished from Phillips' contractual right to utilize the filing provisions of Section 4, was decided solely on the basis of Phillips' costs (R. 327). On this basis, Phillips was found to be entitled to retain the Section 4(e) increases. With this finding there can be no complaint. Two of the increases, however, were based on rate increases being collected subject to refund by El Paso Natural Gas Company and Panhandle Eastern Pipe Line Company. Rates for these com-

[17] Two of the three contracts (including the only one involving gas destined for California) also provided for decreases in Phillips' price in the event of corresponding deflation and a reduction in the pipeline company's rates. The third had also originally provided for a decrease but, after the fact of increase in the price indices had become established, was amended to remove the downward adjustment.

panies had not yet been finally determined by the Commission. Accordingly, Phillips' increases to these two pipeline companies were given only tentative effect pending final determination of their rates. Should the full increase not be allowed to the purchasing pipeline company, Phillips will be permitted to retain only that portion of its otherwise justified increase which is proportional to the increase allowed the pipeline (the limit of the contractual consent) and will be required to refund the balance (R. 329).[18]

Contract provisions permitting price escalations at indefinite times are clearly valid and enforceable. The U. S. Court of Appeals for the Tenth Circuit has twice upheld the specific type of provision here involved as being determinative of the rate on file. *Phillips Petroleum Co.* v. *Federal Power Commission*, 227 F. 2d 470 (1955), cert. denied sub nom. *Michigan-Wisconsin Pipe Line Co.* v. *Phillips Petroleum Co.*, 350 U.S. 1005;[19] *Kerr-McGee Oil Industries, Inc.* v. *Federal Power Commission*, 260 F. 2d 602 (1958). In *Texas Gas Transmission Corporation* v. *Shell Oil*

[18] The tentative effect of the increases relates only to amount. The justification of the entire increase has been accepted by the Commission and is no longer subject to question. After specifying the procedure to be followed to determine whether the increases ultimately allowed the pipeline companies are "sufficient to permit Phillips under its contract to file the increased rates involved in Docket Nos. G-11217 and G-10883", the Commission stated: "Of course, no other matter with respect to these two dockets will remain open." (R. 329)

[19] The contract considered by the Tenth Circuit was one of the contracts now attacked by California. So far as this contract is concerned, California's present contentions constitute a collateral attack on the Tenth Circuit decision. Cf. *Michigan Consol. Gas Co.* v. *Federal Power Commission*, 203 F. 2d 895, 901 (3rd Cir. 1953).

Company, 363 U.S. 263 (1960), no question was raised as to the validity of the escalation clause in question. Indeed, in its *Cities* decision, *Atlantic Refining Co. v. Public Service Commission of New York*, 360 U.S. 378, 391 (1959), this Court clearly recognized that "favored-nation" clauses continue to be operative and effective. In *Warren Petroleum Corp. v. Federal Power Commission*, 282 F. 2d 312 (10th Cir. 1960), the Commission was directed to accept the filings of increases based on "favored nation" clauses.

All such contract provisions are of course subject to the provisions of Section 4 with regard to filing and review by the Commission. The fact of the contractual authorization to file for the increase does not determine the right to retain the increase. The effect of such provisions is to do no more than to provide the necessary contractual consent to the use of the filing procedures of Section 4. The Commission retains all of its powers and duties to determine whether an increase which is contractually permitted is otherwise justified.[20]

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[20] In *Mississippi Power & Light Co. v. Memphis Natural Gas Company*, 162 F. 2d 388, 390 (5th Cir. 1947), cert. denied 322 U.S. 770, the statement is made that a "'favored nation' clause became inoperative after the passage of the Natural Gas Act." This statement is in no way inconsistent with the later decisions of this Court and of the Court of Appeals for the Tenth Circuit. What was meant by the Fifth Circuit was simply that, after the passage of the Act, *all* contract provisions are inoperative to bring about a change in rates unless and until a proper filing is made with the Commission. The statement is equally applicable to contract provisions for increases in definite amounts at definite times. California does not go so far as to contend that all price increase provisions are contrary to public policy, yet one has no greater or lesser standing than another and no basis exists for distinguishing one type of provision from another.

California now contends the Commission erred in even considering whether these increases were justified by Phillips' costs (Br. No. 73, pp. 56-61). California urges that the Commission should have rejected these Section 4 filings out of hand, regardless of whether the increases were otherwise justified.[21]

The basis which California suggests for such cavalier treatment is not clearly defined. California argues that contractual provisions of this kind are invalid "on public policy grounds" (Br. No. 73, p. 60). Precisely what public policy was violated by the Commission's allowance of these increases on the basis of Phillips' costs is not specified.

Reduced to its substance, California's position constitutes an attempt to condemn valid contractual provisions on the basis of nothing but opprobrious language. Contrary to the assertions of California, there is no "spiral". The same effect which California now condemns also occurs when the Commission allows income tax payments as an item of expense —the higher revenues necessary to cover the tax payments create greater taxable income which requires still higher revenues. No suggestion has been made that this effect makes allowance of income tax expense contrary to public policy. Nor has it been thought that any "spiral" results. The final answer is determinable from the beginning by recognized mathematical processes. In similar fashion, the total increase permitted by these contractual provisions is readily determinable and but one increase is required (R. 8-10).[22]

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[21] Wisconsin also attacked these contractual provisions in the court below. It has abandoned those contentions here.

The use by California (and the Commission) of the opprobrious adjective "spiral" obscures the real purpose of that part of these contractual provisions which requires that the purchasing pipeline must itself have received a general increase before Phillips is entitled to an increase. That provision was intended to and does operate to assure the pipeline that, regardless of increases in the commodity index, it will not have to pay Phillips an increase in price unless the pipeline itself first receives a corresponding increase in rates. That part of the price increase provision was intended for the benefit of the purchaser to protect it from a squeeze between its gas purchase costs and its resale rates. The relationship to the pipeline rate which California condemns as creating a "spiral" actually serves as a restriction upon the amount of increase which Phillips may request at one time. If there are successive increases to Phillips, it is only because the contract did not permit Phillips to include the full increase to which it was entitled in its first rate increase filing.

Nothing in this record would justify the Commission in acting as California demands. The Commission expressly so found (R. 327). In *South Carolina Generating Co.* v. *Federal Power Commission*, 249 F. 2d 755, 765 (4th Cir. 1957), cert. denied 356 U.S. 912, the Commission had ordered the deletion of an escalation clause from rate schedules providing rates for the future. The court there stated:

> "We recognize that the retention or elimination of such a [an escalation] clause is a matter for the determination of the regulatory body upon findings of fact."

Whatever the powers of the Commission might be with regard to the future effect of these contract provisions, this principle is clearly applicable where, as here, the contention is that the Commission should retroactively delete such provisions. To accede to California's demand would mean outright confiscation, since the result would be to further reduce revenues which were already below cost (R. 325-326).

In an attempt to avoid the express findings of the Commission in this proceeding, California relies upon Commission statements in other proceedings—to which Phillips was not a party. One decision cited is *Michigan-Wisconsin Pipe Line Co.*, 13 FPC 326, 348-349 (1954) (Br. No. 73, p. 58). It has been judicially determined that the *Michigan-Wisconsin* proceeding is *not* binding upon Phillips. *Phillips Petroleum Company* v. *Federal Power Commission*, 227 F. 2d 470, 476 (10th Cir. 1955), cert. denied sub nom. *Michigan-Wisconsin Pipe Line Co.* v. *Phillips Petroleum Co.*, 350 U.S. 1005. Another decision cited by California is *The Pure Oil Co.*, 25 FPC 383 (1961) (Br. No. 73, p. 58). Although quoting extensively from this decision, California refrains from quoting those portions of the Commission's decision in *Pure* in which the Commission found that any proscriptive action must be limited to *future* contracts:

> "However, we are convinced that we cannot declare the escalation provisions in Pure's contracts with El Paso void or voidable, and thus in effect strike them from the contracts. There is no question but that these exceedingly material parts of the contracts were a basic part of the exchange between the parties in arriving at these agreements. Under familiar rules of law, if these material provisions are stricken, the contracts,

> which lack any provisions for the severability of parts found invalid, must also fall. This would result in legal and regulatory problems that might cause material harm to the public, harm that might well exceed the injurious effects of the escalation provisions themselves. For example, if these provisions were stricken and the contracts fell, the producer's sales might then presumably constitute *ex parte* offerings of gas and the producer could change its rates at will, unimpeded by any contractual limitations of the kind that presently exist. Thus, instead of being limited under the *Mobile* and related decisions only to increases permitted by contractual provisions, the company could file for increases whenever it happened to feel justified in doing so. Thus the uncertainty and spiraling prices resulting from the escalation clauses might well be compounded many times over." (25 FPC at 388)[22]

The drastic treatment of these contractual provisions which California demands is clearly beyond the power of the Commission. In *Willmut Gas & Oil Company* v. *Federal Power Commission*, 294 F. 2d 245, 250 (D.C. Cir. 1961) a similar contention, that the Commission abused its discretion by failing to reject certain increases without further consideration, was

[22] The Commission rejected Pure's filing, but solely on the basis that the favored nation provision had not been triggered. On the basis of this finding, the Commission's action was affirmed. *The Pure Oil Co.* v. *Federal Power Commission*, 299 F. 2d 370 (7th Cir. 1962). The court did not consider the Commission's comments with respect to escalation clauses, since the Commission had in fact taken no action on the basis of such statement. The Commission's comments as to the *ex parte* rights which would come into existence in the event its action should cause the fall of the entire contracts are consistent with similar observations of this Court in *Sunray Mid-Continent Oil Co.* v. *FPC*, 364 U.S. 137, 155 (1960).

answered by the statement that even the broad powers granted to the Commission do not:

> ". . . authorize an order, rule or regulation which would nullify or restrict the right of a natural gas company to change the rates under which it offers to furnish service, subject only to the requirement of Section 4(d) of the Act that it notify the Commission of the changes, so that it may proceed under Section 4(e)."

The obligation of the Commission to review increases based on contractually authorized filings may not be avoided by assertions that the contract provisions violate some unstated public policy. The public policy which is controlling here is that expressed by this Court in *United Gas Pipe Line Co.* v. *Memphis Light, Gas & Water Div.*, 358 U.S. 103, 113-114 (1958):

> "It seems plain that Congress, in so drafting the statute, was not only expressing its conviction that the public interest requires the protection of consumers from excessive prices for natural gas, but was also manifesting its concern for the legitimate interests of natural gas companies in whose financial stability the gas-consuming public has a vital stake. Business reality demands that natural gas companies should not be precluded by law from increasing the prices of their product whenever that is the economically necessary means of keeping the intake and outgo of their revenues in proper balance; otherwise procurement of the vast sums necessary for the maintenance and expansion of their systems through equity and debt financing would become most difficult, if not impossible. This concern was surely a proper one for Congress to take into account in framing its regulatory scheme for the natural gas industry, cf. Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 603, 88 L Ed. 333,

> 345, 64 S. Ct. 281, and we think that it did so not only by preserving the 'integrity' of private contractual arrangements for the supply of natural gas, 350 U.S. at 344 (subject of course to any overriding authority of the Commission), but also by providing in § 4 for the earliest effectuation of contractually authorized or otherwise permissible rate changes consistent with appropriate Commission review."

Here the Commission has acted in accord with the policies which Congress so formulated. It has reviewed the increases and permitted them to stand on the basis of methods which California espouses and on findings which California does not challenge. California is entitled to nothing more.

CONCLUSION

For the reasons stated above, it is respectfully submitted that the Commission's order should be affirmed.

Respectfully submitted,

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In the Supreme Court of the United States

OCTOBER TERM, 1962

No. 72

STATE OF WISCONSIN AND PUBLIC SERVICE COMMISSION OF WISCONSIN, AND PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK, PETITIONERS

v.

FEDERAL POWER COMMISSION, PHILLIPS PETROLEUM CO.

No. 73

PEOPLE OF THE STATE OF CALIFORNIA AND PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, PETITIONERS

v.

FEDERAL POWER COMMISSION, PHILLIPS PETROLEUM CO.

No. 74

LONG ISLAND LIGHTING COMPANY, PHILADELPHIA ELECTRIC COMPANY, AND THE UNITED GAS IMPROVEMENT COMPANY, PETITIONERS

v.

FEDERAL POWER COMMISSION, PHILLIPS PETROLEUM CO.

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR THE FEDERAL POWER COMMISSION

OPINIONS BELOW

The opinion of the court of appeals (R. 410) is reported at 303 F. 2d 380. The orders of the Federal

Power Commission terminating proceedings (R. 251) and denying rehearing (R. 395) are reported at 24 F.P.C. 537 and 1008, respectively. The presiding examiner's decision (printed in part at R. 35) is reported at 24 F.P.C. 590.

JURISDICTION

The judgment of the court of appeals was entered on November 30, 1961 (R. 431–432). Petitions for writs of certiorari were granted on May 14, 1962 (R. 432–434), 369 U.S. 870. The jurisdiction of this Court rests on 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

QUESTIONS PRESENTED

1. Whether the Commission, in a proceeding initiated under Section 5(a) of the Natural Gas Act to establish the future rates of an independent producer of natural gas, was required to use the individual company cost-of-service approach to rate making, despite its conclusion that the method is unworkable as applied to producers.

2. Whether the Commission, having found that the producer's cost of service for the test year substantially exceeded its revenues (including those generated by the increases in issue), properly concluded that no refunds were due under Section 4(e) for past ("locked-in") periods.

3. Whether the Commission erred in failing to reject certain proposed rate increases based on spiral escalation clauses.

STATUTES INVOLVED

The pertinent statutes, Section 4(e), 15 U.S.C. 717c(e) and Section 5(a), 15 U.S.C. 717d(a) of the Natural Gas Act, are set forth in Appendix A, *infra*, pp. 65–66.

STATEMENT

The order here under review is a sequel to this Court's decision in *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672. The Court there affirmed the decision of the court of appeals,[1] which set aside a Commission order holding that it lacked jurisdiction over the rates of Phillips Petroleum Co., an independent producer of natural gas. On remand, the Commission, on November 22, 1954, reinstituted its investigation of Phillips' rates under Section 5(a) of the Natural Gas Act.[2] That section empowers the Commission, either upon its own initiative or upon complaint, to conduct a hearing with respect to the rates of any natural gas company and—if it finds those rates to be unjust, unreasonable, unduly discriminatory, or preferential—to determine prospectively the just and reasonable rates to be thereafter in force.

Later, the Commission consolidated with this Section 5(a) docket (No. G–1148) twelve other proceedings under Section 4(e)[3] of the Act resulting from the Commission's suspension of increased rates filed by Phillips. Under Section 4(e), a proposed increased rate filed by a natural gas company may be suspended

[1] *Wisconsin* v. *Federal Power Commission*, 205 F. 2d 706 (C.A.D.C.).

[2] 52 Stat. 823, 15 U.S.C. 717d(a), Appendix A, *infra*, p. 66.

[3] 52 Stat. 822, 15 U.S.C. 717c(e), Appendix A, *infra*, pp. 65–66.

by the Commission for a maximum period of five months; if the Commission has not by that time determined the issue of justness and reasonableness, the rate may nonetheless be put into effect, but in that event the proponent may be placed under a duty to refund such portion of the amounts collected as the Commission may later find unjustified. All of the suspended rates in the present case (with the minor exception of Docket No. G–8623, involving an annual increase of only $23,324) have been superseded by later filings, which in turn were suspended in other proceedings not here involved. In other words, the Section 4(e) proceedings involved in this case do not concern rates which were currently in effect as of the date of the Commission's decision, but relate to so-called "locked-in" periods—*i.e.*, periods which commenced on the effective date of the rate increase at issue and ended on the effective date of a subsequent and superseding rate increase. Thus, on this aspect of the case, only refunds are in issue.

The hearings in the consolidated proceedings began on June 26, 1956, and ended on December 18, 1957, consuming a total of 82 hearing days. Thirty-one parties intervened, including the petitioners in the three cases now before this Court.[4] The record ran to some 27,000 pages. Extensive briefing followed, the last reply brief being filed on May 5, 1958. On

[4] Petitioners in No. 74 are collectively referred to as the Eastern Seaboard Companies.

April 6, 1959, the examiner's decision, over 300 pages in length, was handed down.[5]

The Examiner's Decision.—The examiner found that in the test year, 1954, Phillips sold more than 588 million Mcf of natural gas, of which 491 million, or 71.3%, were sold for resale in interstate commerce. Its own production in that year was over 375 million Mcf, of which more than 226 million was "dry gas" (also sometimes called "gas-well gas"), and the remaining 149 million was produced together with oil. It purchased 408 million Mcf from other producers[6] (R. 74, 340).

The annual rate increases involved in the Section 4(e) proceedings consolidated in these hearings amounted to $5¼ million. The proposed increases were to levels ranging between 5.5¢ per Mcf and 13.5¢ per Mcf, except for one increase to 17¢ per Mcf (R. 75). Increases suspended subsequent to December 14, 1956, were not consolidated and are not part of this case.

These hearings proceeded, and the entire record was compiled, on the assumption that Phillips' cost of service for the test year, 1954, was the appropriate yardstick for prescribing its rates. Several studies were put in evidence purporting to show Phillips' total cost of service for that year (*i.e.*, all operating expenses, including depreciation, depletion, and taxes,

[5] 24 F.P.C. 590; R. 35. (The examiner's decision is not reproduced in full in the joint appendix.)

[6] The difference between the total volume sold and the larger amount produced and purchased consists of company uses, residue returned to leases, etc.

plus a fair return on net investment). The results of these studies (R. 93), together with the examiner's findings (R. 212), are shown by the following table:

	Total	Per Mcf (cents
Phillips	$92,309,438	18.793
F.P.C. Staff	42,024,180	8.55
Eastern Seaboard Companies:		
At 9% rate of return	55,046,180	11.207
At 12% rate of return	60,489,481	12.315
Wisconsin	48,647,832	9.904
Examiner	57,280,218	11.662

The examiner's figure of $57,280,218 for cost of service was some $14 million *above* Phillips' actual test year revenues prior to the filing of the rate increases in the Section 4(e) proceedings involved here—increases providing $5¼ million in additional revenues. He ordered Phillips to calculate a rate which, applied to the 1954 volumes, would produce revenues substantially equal to the cost of service (R. 214) he had determined. This rate, with appropriate adjustments for quality, pressure, delivery point, etc., would then be applied to all rate schedules in effect at the time of approval by the Commission. That is, future rates from 1959 on were to be based on the 1954 cost of service.

The examiner noted (R. 212):

> * * * The aggregate increase of $14 million annually, resulting from this decision, would be roughly $8¾ million higher than the $5¼ million increase reflected in Phillips' consolidated Sec. 4(e) dockets—which the interveners have here expressed their willingness to accept.

The Commission's Opinion.—It was not until its receipt of the examiner's report that the Commission

had its first opportunity to examine fully a major contested case in which an attempt had been made to develop just and reasonable rates for an independent producer of natural gas.[7] On September 28, 1960, it issued Opinion No. 338 (R. 251), the subject of this appeal. In the Commission's view, the most important question before it was whether the individual company cost-of-service method should be applied in this proceeding at all (R. 254). It is the Commission's decision on that point which gives rise to most of the petitioners' objections.

The Commission concluded (R. 256), in the light of its experience in this and other cases during the previous five years, that the original-cost, prudent-investment, rate-base method which had been used in the regulation of electric utilities and natural gas pipelines was not a workable method for purposes of fixing the rates of independent producers of natural gas. It declared that the ultimate solution of the problem of producer regulation lies in the determination of fair prices for the commodity, based on the reasonable financial requirements of the industry in each production area, and not on the investment and expenses of each individual natural gas company.

In addition to its general objections to the use of the individual company cost-of-service method, the Commission noted a serious infirmity in the particular record before it, *i.e.*, the fact that it was based on a

[7] A number of minor cases, involving slender records, relatively few sales, and little or no attempt to face the basic problems raised here, are cited in footnotes 8 and 9 of the Commission's opinion (R. 264).

six year-old test year, 1954. It observed, on the basis of its knowledge of conditions in the industry, that costs and prices of gas in the field had greatly increased since 1954 and concluded that to require the company to file decreases in rates in 1960 based on so remote a test year would be "a result without reason or justice." R. 324–325. Accordingly, concluding that it was inappropriate to prescribe rates for the future on the basis of the present record, the Commission terminated the Section 5(a) rate investigation in the original docket, No. G–1148.

However, inasmuch as the evidence in this case had been presented solely on a cost-of-service basis, the Commission, despite its fundamental disapproval of that method, computed a company-wide cost of service for the 1954 test year and utilized it to dispose of the Section 4(e) proceedings. It arrived at a cost of service of $54,525,315, or 11.1009¢ per Mcf, subject to adjustments for purchased gas costs, gathering taxes and royalties (R. 401).[8] This figure, it found, substantially exceeded the test-year jurisdictional revenues of $45,568,291 (R. 326). The Commission further found that the increased rates involved in the Section 4(e) dockets had produced revenues less than Phillips' cost of service during the periods that they

[8] That is to say, if Phillips' rates were to be raised to cover cost of service, these three cost items would increase to above the levels at which they are included in the cost of service figure given. The reason for this is that these costs fluctuate with rates. The Eastern Seaboard Companies pointed out in their brief below that this suggests a total revenue requirement, after adjustments, of $59,725,315, or a unit cost of 12.16¢ per Mcf.

were in effect. It also noted that the record failed to indicate that any of those rates were unduly discriminatory or preferential. Consequently, the Commission decided that no refunds should be required in any of the Section 4(e) cases and, so finding, terminated all but two of those cases.

The two Section 4(e) proceedings not terminated were kept open pending determination of the effect of "spiral escalation" clauses in Phillips' contracts.[9] In one of these dockets, No. G–11217, Phillips had filed an increase under a spiral escalation clause which it contended was activated by a rate increase filed by El Paso Natural Gas Co. in Docket No. G–4769,[10] 22 F.P.C. 260. El Paso argued that the spiral escalation clause was not activated and provided no basis for Phillips' rate increase in Docket No. G–11217. The Commission held (R. 328) that if the amount of escalation determined to be allowable in G–4769 turns out to be less than the increase proposed in Docket No. G–11217, the excess portion would be a unilateral increase barred by the *Mobile* doctrine, *United Gas Pipe Line Co.* v. *Mobile Gas Service Corp.*, 350 U.S. 332, and would have to be refunded. The other docket,

[9] Such clauses provide that when a specified commodity price index increases by more than a prescribed number of points, and a general increase in the pipeline's resale rates has gone into effect, then Phillips' rates to the customer may be proportionately increased (R. 327).

[10] El Paso's rates in G–4769 were allowed to become effective April 15, 1955, but, following court review, are again before the Commmission on remand. *El Paso Natural Gas Co.* v. *F.P.C.*, 281 F. 2d 567 (C.A. 5), certiorari denied, *sub nom. California* v. *Federal Power Commission*, 366 U.S. 912.

No. G–10883, was left open because of similar considerations with respect to increases filed by Panhandle Eastern Pipeline Co. in Docket No. G–2506. If the rates finally approved in G–2506 are insufficient to justify Phillips' proposed increases in G–10883, a refund will be necessary (R. 328–329).

Simultaneously with its opinion in this case, the Commission issued its Statement of General Policy 61–1 (R. 343), setting forth two sets of ceiling prices for natural gas in each of the country's major producing areas. New sales at higher prices would not be certificated, the Commission announced, without a justification of the proposed price. Moreover, proposed price increases (on gas already certificated for sale) to prices above those prescribed would be suspended under Section 4(e) and then permitted to go into effect only subject to refund. The Commission also announced that it would begin a series of comprehensive rate hearings, each designed to cover a major producing area and to establish just and reasonable rates for all producers in that area.

The Decision Below.—The court of appeals affirmed, Judge Fahy dissenting in part. The opinion points out (R. 417) that the rates in issue are not rates of conventional public utilities, such as pipelines, but, rather, are charges for a processed commodity which varies widely in physical quality, points and terms of delivery and other factors, and that such charges involve "hundreds of producers, hundreds of contracts, and thousands of rate filings." No one, said the court (R. 418), contends that a cost of service could be

meaningfully determined for each contract, *i.e.*, for each Section 4(e) proceeding. The court held that in dealing with the Section 4(e) proceedings the Commission decided "[t]he only question of substance," *i.e.*, whether there should be refunds (R. 419). Having determined that Phillips' revenues in the test year fell short of its cost of service by $9 million, and that the increases involved in the Section 4(e) proceedings were far less than needed to wipe out that deficit, the Commission, in the court's opinion, reasonably concluded that no refunds were due (R. 420–421). It terminated those proceedings, but only "after deciding the basic and dispositive issue" before it (R. 420).

Noting with approval the Commission's adoption of interim controls (by its Policy Statement) and its initiation of area rate proceedings (now in progress), the court sustained the termination of the Section 5(a) proceeding on the ground that the Commission had ample authority to fashion new regulatory standards and to abandon those found unsatisfactory and unworkable (R. 421). The court also rejected as unfounded the charge that the Commission "has abandoned regulation of these rates for this interim period" (R. 425).

Judge Fahy agreed (R. 427) that the Commission's "[e]mbarkation upon the area method * * * does not necessitate judicial intervention, certainly not at this time." He was of the view, however, that, having conducted the evidentiary proceeding on the assumption that the cost-of-service method would be utilized, the Commission should proceed further upon that

basis in this case, "though it may need to update the record" (*ibid.*).

SUMMARY OF ARGUMENT

1. The Natural Gas Act does not require the Commission to use any particular rate-making formula. *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591, 600–601. On the contrary, many decisions of this and other courts make clear that the selection of an appropriate regulatory method is a matter which lies within the sound discretion of the Commission. No court has even intimated that the individual company cost-of-service technique must be employed in regulating the rates of independent producers.

In the instant case, the record was made on the assumption that Phillips' estimated cost of service would determine its rates. After careful examination of this record (the first to come before it in a major independent producer case) the Commission decided, for sound and clearly articulated reasons, that the traditional company-by-company cost method did not assure meaningful results when applied to independent producers of natural gas. It pointed out, among other things, that the stable relationship between input (investment) and output (service) which characterizes pipelines and conventional public utilities, and which justifies computing return (*i.e.*, profits) on the basis of investment, is almost entirely lacking in the case of independent producers. It observed that to use the costs of each individual company as the yardstick for determining its rates would reward the inefficient and penalize the efficient, invite royalty owners to lease

their properties to the highest-cost producers, give rise to cost allocation problems (as between oil and gas) of unparalleled difficulty and of inordinate weight in the final rate determination, and involve the intolerable administrative burden of repeated and complex rate cases for each of several thousand independent producers.

Section 5(a) authorizes the Commission to prescribe rates for the future only if it finds existing rates to be unjust and unreasonable. Here the Commission reasonably decided that the record before it, premised entirely on rate-making assumptions of dubious applicability, made this finding inappropriate. Moreover, even if the rate-base method, despite its severe limitations as a permanent regulatory tool, could be made to do temporary duty, it was still plain to the Commission that Phillips' rates for 1960 and future years could not fairly be fixed on the basis of a stale (1954) test year. Thus, the Commission was faced with a choice between two courses: On the one hand, it could assign its limited personnel the task of compiling a new cost-of-service record in order that Phillips' rates might be fixed by the method already found wanting. On the other hand, it could devote its energies and those of its staff to the development of a new approach—the area-rate approach—which alone, in its view, held out the prospect of sound and comprehensive regulation of producer rates. The Commission did not abuse its discretion in adopting the latter course.

This does not mean, as petitioners suggest, that the Commission has abandoned the regulation of producer

rates during the interim period required for the establishment of definitive area rates. Its termination of the Section 5(a) proceeding here was accompanied by the issuance of a Statement of General Policy, designating interim ceiling prices for each major producing area. These mark the point at which the Commission refuses to grant certificates for initial sales and suspends proposed rate increases under existing contracts. Through this and a combination of other measures the Commission has now succeeded in halting the upward trend in natural gas prices which prevailed for many years, and in numerous instances has secured lower current rates, substantial refunds, and assurances of future price stability. The preference of these petitioners for a particular method of rate-making should not be permitted to obscure the substantial accomplishments of the Commission in the past two years or the substantial promise of the area-rate approach.

Area rate proceedings are well under way in two major producing areas, the Permian Basin of Texas and South Louisiana. If these proceedings are permitted to go forward without interruption or slackening, determinations governing a substantial portion of Phillips' sales *and sales of most other major producers as well* may be available within roughly the same period of time that would be required to complete a Section 5(a) proceeding covering Phillips alone. However, a decision compelling the Commission to bring the records up to date in this case and in other outstanding Section 5(a) proceedings involv-

ing individual companies would necessarily tend to delay the area rate program.

It is clear that the Commission cannot effectively pursue both objectives at the same time. It cannot make optimum progress in establishing area rates if simultaneously it must also establish individual company rates according to the rate-base technique it has found wanting. It cannot fix rates for the industry as a whole if it must continue, company by company, to undertake the kind of proceeding to which the Court referred when it noted that "* * * the delay incident to determination in § 5 proceedings * * * appears nigh interminable." *Atlantic Refining Co. v. P.S.C. of New York*, 360 U.S. 378, 389. Granting that there are problems of transition, it should not be compelled to expend its necessarily limited capacities in travelling two divergent roads leading to inconsistent ends.

2. The Section 4(e) proceedings involved in this case relate to increased rates which were in effect during past periods, but had been superseded by subsequent filings (which in turn became the subject of other Commission proceedings). The increases here, therefore, have no current or future application. The only question as to these rates was whether the Commission had basis for ordering refunds of amounts collected during the past periods in question. The Commission found (and petitioners do not dispute) that in the 1954 test year Phillips' cost of service substantially exceeded its revenues and that the increased rates under review were not sufficient to close this gap. In these circumstances, termination of the Section 4(e) proceedings was plainly justified.

3. In No. 73, California objects to the Commission's refusal, in three dockets, to outlaw "spiral escalation" clauses, *i.e.*, clauses in Phillips' contracts which provide for increases in its rates when the rates of its customer, the pipeline, have risen. (Wisconsin, which raised a similar argument below, has abandoned it here.) As to two of the three dockets to which California's objection relates, its claim is premature because no final order has been entered; as to the third docket, California is not aggrieved because the sales in question do not pertain to gas destined for that State.

In any event, the objection is groundless. In essence, the contention is that the Commission should have declared spiral escalation clauses contrary to the public interest and void *ab initio*, in which case the rate increases filed pursuant to them would not have been contractually authorized and would thus have to be rejected regardless of their relationship to the company's costs. See *United Gas Pipe Line Co.* v. *Mobile Gas Service Corp.*, 350 U.S. 335. In the absence of any statute, common-law rule or administrative regulation condemning spiral clauses, the Commission was not required to nullify them as a matter of law. The courts have given effect to such clauses. Indeed, this Court has upheld the right of a seller to file for rate increases under a contract which, in effect, gave unlimited authorization for such filings and therefore went well beyond the escalation clauses here. And, although the Commission has in the last two years issued orders banning spiral clauses for the future, it

was surely under no compulsion (assuming it had the power to do so) to make those orders retroactive.

ARGUMENT

I

THE COMMISSION WAS NOT REQUIRED TO FIX PHILLIPS' RATES FOR THE FUTURE BY USING THE INDIVIDUAL COMPANY COST-OF-SERVICE METHOD

A. THE NATURAL GAS ACT DOES NOT REQUIRE THE USE OF A PARTICULAR METHOD OF RATE-MAKING

Although all of the petitioners maintain that the Commission must continue to use the "established" method of price determination on an interim basis until an alternative approach has been fully developed, only California takes the position that the Commission lacks power, in the long run, to abandon that method as a permanent tool for regulating the rates of independent producers. It argues that the existing formula is "a lawful, established and effective method of determining just and reasonable rates, and for these reasons must not be abandoned" (No. 73, Br. 36 *et seq.*). In the light of California's contention, it is important to establish at the outset that neither Congress nor the courts have ever undertaken to prescribe the rate-making formula which must be used in regulating pipelines or independent producers, but, instead, have accorded the Commission broad discretion to select the method it deems appropriate.

The debate between exponents of the individual company cost-of-service method, on the one hand, and of the "commodity value" or area-rate approach, on the other hand, is of relatively recent vintage. But

the broader question whether the Commission is bound to the use of a particular rate-making formula first arose in the course of controversy as to whether the agency was obliged to allow a pipeline a return on the "fair value" or "replacement cost new" of its properties (the traditional method under *Smyth* v. *Ames*, 169 U.S. 466) or was free to adopt a new method whereby the return was computed on the prudent investment in the pipeline's properties and facilities (plus working capital and minus accrued depreciation). That issue was resolved by this Court in *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591, which upheld the power of the Commission to fix rates by the then unorthodox prudent investment rate-base method.

Petitioners would have it that the unorthodoxy of one generation of Commissioners fixed an inviolable dogma for the next. It is the method which the Court permitted in *Hope—i.e.*, the individual company cost-of-service method, employing a prudent investment rate base—which all of the petitioners now characterize as the "established" method and which they insist must be applied (either permanently or temporarily) to the novel task of regulating the prices of independent producers. In *Hope*, however, this Court took pains to avoid any suggestion of such a limitation (320 U.S. at pp. 600-601):

> * * * Congress, however, has provided no formula by which the "just and reasonable" rate is to be determined. It has not filled in the details of the general prescription of § 4(a) and § 5(a). It has not expressed in a specific

> rule the fixed principle of "just and reasonable".

After rejecting the "fair value" contentions,[11] the Court, citing *Federal Power Commission* v. *Natural Gas Pipeline Co.*, 315 U.S. 575, went on (320 U.S. at p. 602) to state its holding in terms which preclude fastening upon the Commission any specific method of rate making:

> We held in *Federal Power Commission* v. *Natural Gas Pipeline Co., supra*, that the Commission was not bound to the use of any single formula or combination of formulae in determining rates. Its rate-making function, moreover, involves the making of "pragmatic adjustments." *Id.*, p. 586. And when the Commission's order is challenged in the courts, the question is whether that order "viewed in its entirety" meets the requirements of the Act. *Id.*, p. 586. Under the statutory standard of "just and reasonable" it is the result reached not the method employed which is controlling.

The refusal of the Court to adopt or approve the cost-of-service method as such, though upholding rates fixed by that method, was particularly significant in light of the fact that the Power Commission in *Hope* sought to have its order sustained by arguing that, although the cost-of-service method had not been expressly written into the statute, Congress intended cost of service to be used insofar as constitutionally

[11] Contentions based on the "fair value" rule were rejected on the elemental ground (320 U.S. at p. 601) that "rates cannot be made to depend upon 'fair value' when the value of the going enterprise depends on earnings under whatever rates may be anticipated."

possible.[12] In short, the *Hope* decision rejected the substance of the very contention now advanced by petitioners.[13]

Later, in *Colorado Interstate Gas Co.* v. *Federal Power Commission*, 324 U.S. 581, which was addressed to the question whether the Commission had power to include the producing properties of an interstate pipeline in its rate base, the Court, answering this question affirmatively, suggested that the Commission would not be precluded from using an area-price approach ("Some have thought that to be the wiser course." *Id.* at 601) in lieu of the rate-base method.

The courts of appeals have similarly refrained from reading into the Acts a mandate to use the original-cost, rate-base formula. *Panhandle Eastern Pipe*

[12] *Federal Power Commission, et al.* v. *Hope Natural Gas Company*, S. Ct. No. 34, October Term, 1943, Brief for Petitioners, pp. 36–39.

[13] It is noteworthy that, while the Federal Power Act, 49 Stat. 838, 16 U.S.C. 791a–825r (upon which the Natural Gas Act was modeled) was under consideration in Congress, this Court's reaffirmance in *West* v. *Chesapeake & Potomac Tel. Co.*, 295 U.S. 662 (1935), of the *Smyth* v. *Ames* fair-value rule, gave rise to such grave doubts as to the constitutionality of the original-cost rate-base formula that the House Committee deleted (H. Rep. No. 1318, 74th Cong., 1st Sess., p. 30) a provision in the bill as it had been passed by the Senate which would have provided that in determining just and reasonable rates, the Commission shall fix a rate base "not in excess of the actual legitimate cost of the property." S. 2796, Section 208(c), 79 Cong. Rec. 9065; see also S. Rep. No. 621, 74th Cong., 1st Sess., pp. 20, 40. It is clear, therefore, that the original-cost rate-base method, which petitioners characterized as "traditional" and "conventional" was not written by Congress into either the Federal Power Act in 1935 or the Natural Gas Act in 1938.

Line Co. v. *Federal Power Commission*, 143 F. 2d 488, 491–494 (C.A. 8), affirmed, 324 U.S. 635; *Cities Service Gas Co.* v. *Federal Power Commission*, 155 F. 2d 694, 698–699 (C.A. 10), certiorari denied, 329 U.S. 773; *Interstate Natural Gas Co.* v. *Federal Power Commission*, 156 F. 2d 949, 951 (C.A. 5), affirmed, 331 U.S. 682; *Pennsylvania Water & Power Co.* v. *Federal Power Commission*, 193 F. 2d 230, 241–243 (C.A.D.C.), affirmed, 343 U.S. 414.

Notwithstanding the clarity of these rulings, the decision of the Court of Appeals for the District of Columbia Circuit in *City of Detroit* v. *Federal Power Commission*, 230 F. 2d 810 (C.A.D.C.), certiorari denied, 352 U.S. 829, gave rise to temporary uncertainties. In that case, upon which petitioners rely heavily (No. 72, Br. 32–33; No. 73, Br. 25; No. 74, Br. 31), the court, in considering the price which a pipeline could charge its ratepayers for gas produced from its own wells, stated (230 F. 2d at p. 818):

> [Cost of service] has been repeatedly used by the Commission, and repeatedly approved by the courts, as a means of arriving at lawful—'just and reasonable'—rates under the Act. *Unless it is continued to be used at least as a point of departure,* the whole experience under the Act is discarded and no anchor, as it were, is available by which to hold the terms 'just and reasonable' to some recognizable meaning. [Emphasis supplied.]

Significantly, however, the court expressly refused to place its decision on the ground urged by petitioners in that case, *i.e.*, that "only a traditional rate-base

method can lead to 'just and reasonable' rates, or in any event, on the ground that the field price method cannot do so" (230 F. 2d at p. 814). Instead, it stated (*id.* at 815):

> * * * the allowance of a field price for the utility's own produced gas as an element in the ultimate composition of rates is not unlawful merely because it departs from the traditional rate-base method. * * *

All the court held in *City of Detroit* is that where the Commission adopts the cost-of-service method to fix rates of a pipeline, but then, instead of consistently following that method, uses another method which allows a higher return on the gas production part of the company's operations (230 F. 2d at 818):

> * * * the evidence and findings must show that the increase in rates thus caused is no more than is reasonably necessary for the purposes advanced for [the] increase. Since there is nothing in these proceedings from which such a conclusion could be drawn, they are fatally defective. * * *

Cf. *Mississippi River Fuel Corp.* v. *Federal Power Commission,* 163 F. 2d 433, 443 (C.A.D.C.).

City of Detroit was followed by a series of decisions in the District of Columbia and Fifth Circuits, in which the courts upheld Commission orders denying rate increases to independent producers on the ground that they could not justify such increases merely by showing that the proposed rates were comparable to the going price in the field. *Bel Oil Corp.* v. *Federal Power Commission,* 255 F. 2d 548

(C.A. 5), certiorari denied, 358 U.S. 804; *Forest Oil Corp.* v. *Federal Power Commission*, 263 F. 2d 622 (C.A. 5); *Episcopal Theological Seminary* v. *Federal Power Commission*, 269 F. 2d 228 (C.A.D.C.), certiorari denied *sub nom. Pan American Petroleum Corp.* v. *Federal Power Commission*, 361 U.S. 895.[14] But in sustaining the Commission's judgment that the limited evidence which had been offered to justify a field-price approach was not sufficient to show that the rates proposed were "just and reasonable", the courts did not rule that the individual company cost-of-service approach had to be used. On the contrary, the opinions make unmistakably clear that the choice of the method of fixing independent producer rates was the Commission's responsibility.

Thus, in *Bel Oil*, the first case, the Fifth Circuit declared (255 F. 2d 548, 553–554):

> The regulation of the prices at which thousands of "natural gas companies" may sell to the pipeline companies is a difficult one at its best. It is a field which in many respects re-

[14] The opinion of the Court of Appeals for the District of Columbia Circuit was written by Mr. Justice Reed, retired, sitting by designation. It is informative to note that the same Justice, sitting similarly in a pipeline rate case where a formula used by the Power Commission was under attack, pointed out (*Battle Creek Gas Co.* v. *Federal Power Commission*, 281 F. 2d 42, 46 (C.A.D.C.)): "The role of reviewing courts in passing on the rate-making methods used by administrative agencies is necessarily narrow. * * *" and in support cited the *Natural Gas Pipeline*, *Hope* and *Colorado Interstate* cases, *supra*, and the dissenting opinions in those cases (including one of his own), which would have construed the Gas Act as leaving the Commission a narrower authority to choose rate-fixing methods than the Court's majority decisions actually did.

> quires new formulas to test what is just and reasonable. * * *

In *Forest Oil, supra,* the same court took pains to emphasize that the Commission was not compelled to use any particular formula (263 F. 2d at 626):

> We do not think that either the Commission or the petitioner should be baffled or handicapped in this new field of regulation by any formulas by whatever name they are known. Specifically, if there is an accounting or rate-making formula known to the public utilities industry as a "conventional rate-base method of rate-making" which the Commission in its order of dismissal in this case said must be used at least as a basis of comparison or point of departure, we say the Commission need not require it unless such method is the only way by which the Commission can make its required determination. * * *

Finally, in *Minneapolis Gas Co.* v. *Federal Power Commission,* 294 F. 2d 212 (C.A.D.C.), the District of Columbia Circuit, endorsing the attitude expressed by the Fifth Circuit in the above case, rejected the contention that, in order to determine the justness and reasonableness of producer rates, the Commission is compelled to enter upon a full blown cost-of-service inquiry (294 F. 2d at 216–217):

> * * * Whether in a particular case rate-base proof is necessary is something which the Commission must in the first instance decide, in the light of the statute and the relevant cases. * * * [A]s the Supreme Court has made clear, there are many cases in which rate-base proof is unnecessary. [Citing *Hope, supra.*] In this re-

> gard we note our agreement with the attitude taken by the Fifth Circuit with reference to problems such as those raised in the instant case [citing the *Forest* and *Bel Oil* cases, *supra*]. It may well be that on the record ultimately made before it the Commission will decide that a cost-of-service-rate-base inquiry is not necessary. * * *

Thus, the recent round of independent producer cases has reaffirmed the principle, early established by this Court in *Hope*, that the choice of the appropriate method for determining just and reasonable rates lies within the sound discretion of the Commission.

B. THE COMMISSION HAD SOUND REASONS FOR CONCLUDING THAT THE RATES OF INDIVIDUAL PRODUCERS COULD NOT BE EFFECTIVELY REGULATED ON A COMPANY-BY-COMPANY BASIS

Experience in this case, as well as other rate proceedings, convinced the Commission that the traditional method of regulating public utilities was not "a sensible, or even a workable, method of fixing the rates of independent producers of natural gas" (R. 256). The reasons articulated by the Commission in its opinion (R. 256–269) amply support that conclusion.

The heart of the matter, as the Commission recognized (R. 257), is that, in the case of public utilities, there is usually a close correlation between the amount of money invested in facilities and the amount of service rendered to the public, and it is therefore appropriate to reward utilities in proportion to their respective investments; no predictable correlation obtains, however, between the investment input and the

marketable output of the natural gas producer. One producer, without the slightest imprudence, might invest large sums in exploration and find relatively little gas, while another might discover a bonanza with his first well. The implications of this fact for regulatory purposes were discerned with extraordinary insight by Mr. Justice Jackson in the *Hope* case, *supra*, 320 U.S. at 649 (dissenting opinion):

> The prudent investment theory has relative merits in fixing rates for a utility which creates its service merely by its investment. The amount and quality of service rendered by the usual utility will, at least roughly, be measured by the amount of capital it puts into the enterprise. But it has no rational application where there is no such relationship between investment and capacity to serve. There is no such relationship between investment and amount of gas produced. Let us assume that Doe and Roe each produces in West Virginia for delivery to Cleveland the same quantity of natural gas per day. Doe, however, through luck or foresight or whatever it takes, gets his gas from investing $50,000 in leases and drilling. Roe drilled poorer territory, got smaller wells, and has invested $250,000. Does anybody imagine that Roe can get or ought to get for his gas five times as much as Doe because he has spent five times as much? The service one renders to society in the gas business is measured by what he gets out of the ground, not by what he puts into it, and there is little more relation between the investment and the results than in a game of poker.

As the Commission pointed out (R. 257), a natural gas pipeline is assured a fair opportunity to earn a return. For until it has demonstrated with reasonable certainty that its project is financially feasible it will not be granted a certificate of public convenience and necessity authorizing it to construct its facilities. By contrast, an independent gas producer invests substantial sums without assurance that he will even have a product to sell, much less be able to sell it. Under the cost-of-service method of regulation, the producer who takes the initial risk in a previously unexplored area and proves it productive will often derive the least reward, for he will presumably pay less for his leasehold rights, and therefore have a lower rate base, than those less enterprising producers who follow in his footsteps. Moreover, inasmuch as natural gas royalties earned by the owners of land are usually proportionate to the unit price of the gas sold, the traditional rate-base method would invite royalty owners to lease their properties to the least efficient producers, whose high costs would entitle them to correspondingly high rates. See R. 261.

The regulation of producer rates on a cost basis entails a further anomaly. If the costs of the individual producer are the sole determinant of fair price, it is plain, the Commission observed (R. 261–262), that a rate which is reasonable for one owner of a well may be inadequate or excessive for a co-owner of the same well, so that gas from a single well might have widely varying price tags depending on who was selling it. This consequence is akin to the "delirious results" which Mr. Justice Jackson attributed to the

rate-base method when he remarked in *Colorado Interstate Gas Co.* v. *Federal Power Commission*, 324 U.S. 581, 610:

> * * * These orders in some instances result in three different prices for gas from the same well. The regulated company is a part owner, an unregulated company is a part owner, and the land owner has a royalty share of the production from certain wells. The regulated company buys all of the gas for its interstate business. It is allowed to pay as operating expenses an unregulated contract price for its co-owner's share and a different unregulated contract price for the royalty owner's share, but for its own share it is allowed substantially less than either. Any method of rate-making by which an identical product from a single well, going to the same consumers, has three prices depending on who owns it does not make sense to me.[15]

Another major source of difficulty in attempting to regulate independent producers on a company-by-company cost basis is the fact that a producer can seldom foresee whether any given well will strike gas or oil (if it discovers any minerals at all) or, as is so often the case, both together. It becomes necessary, therefore, under the cost-of-service method, to allocate the producer's dry-hole expenses (*i.e.*, the expenses associated with drilling wells which turn out wholly unproductive) between the two commodities, and also to allocate the production costs of those wells which

[15] *Colorado Interstate* was, of course, decided before it was established by *Phillips* that the Commission has jurisdiction over independent producers.

produce oil and gas jointly. This cost allocation is a great deal more difficult and weighs much more heavily in the ultimate rate determination than the allocations required to be made in the regulation of traditional public utility rates. The Commission found (R. 259) that a great many formulas had been proposed in this proceeding for the cost allocation between oil and gas, and that the difficult choice between one or another method may, in the case of any given producer, mean the difference between bankruptcy and large profits.

Not least of all, there is the intolerable administrative burden of holding repeated rate cases for each of the thousands of independent producers subject to Commission jurisdiction. The Commission's opinion spells out in detail the magnitude of this task (R. 263). As of September 1960, 3,372 independent producers had 11,091 rate schedules and 33,231 separate rates on file with the Commission. The experience of the first six years of producer regulation led the Commission, at that point, to estimate that nearly 13 years would be required in order for its existing staff to dispose of the cases then pending, and that, even if that staff were immediately tripled, the Commission would not reach a current status with respect to its independent producer rate work until 2043 A.D.[16]

[16] The Commission also cited (R. 260) two additional difficulties incident to the use of the individual company, cost-of-service method: (a) The cost of gas per unit depends in part on estimates of reserves. These estimates are subject to wide variance, can never be precise, and often proved highly inaccurate, with qualified experts differing as much as 100% over reserves in the same formation. See *e.g.*, *El Paso Natural Gas*

In light of these considerations, there can be little doubt that the Commission's decision to abandon the individual company method of regulation had a reasoned basis.

C. IN THE CIRCUMSTANCES, THERE WAS NO ABUSE OF DISCRETION IN TERMINATING THE SECTION 5(a) PROCEEDING

As we have indicated, none of the petitioners, with the exception of California, challenges the power of the Commission, in the long run, to abandon the individual company cost-of-service method of determining producer rates and to adopt in its place a new method whereby natural gas is priced as a commodity on an area-wide basis. Petitioners insist, however, that until the area rate proceedings have come to fruition the Commission is obliged to continue regulating producer rates on the basis of the repudiated cost-of-service method, at least where such proceedings have already been initiated and hearings have been completed. Specifically, petitioners contend that the Commission abused its discretion in terminating the Section 5(a) proceeding in this case, after the examiner's decision had already been rendered, without undertaking to fix Phillips' rates for the future.

1. *The record was inadequate for purposes of prescribing future rates on a meaningful basis*

Section 5(a) does not require, or even permit, the Commission to determine just and reasonable rates

Co., Docket No. G-12580, 22 F.P.C. 900, 904, 918, *et seq.* And (b) the federal income tax laws relating to intangible drilling expenses and percentage depletion, as applied to individual producers, present complex and unresolved problems which may bear heavily upon costs.

unless it finds existing rates unjust, unreasonable, unduly discriminatory or preferential.[17] In *Federal Power Commission* v. *Sierra Pacific Power Co.*, 350 U.S. 348, 353, this Court, construing identical language of the Federal Power Act, described the statutory finding as a condition precedent to the exercise of the Commission's power to determine rates. Here, the Commission doubted that it could make a finding that the rates were unjust and unreasonable because the basic assumption upon which the record had been made, *i.e.*, that the company's costs as revealed in the record should be the sole determinant of price, was not, in its view, a workable premise. See *supra*, pp. 7–8, 25–29.

The Commission had a second and independent reason for its decision to terminate the Section 5(a) proceeding. Assuming that the cost-of-service technique, though unsuitable as a permanent regulatory tool, might have been made to do service on an interim basis, there was the obstacle that the record had become seriously outdated. The cost data were for the test year 1954, and the Commission knew from its familiarity with the industry that costs and other conditions had changed with unprecedented speed between that year and 1960. Accordingly, it saw no escape from the conclusion that to require Phillips to file rates for 1960 and subsequent years based upon its revenue requirements of 1954 would be "without reason or justice" (R.

[17] "Whenever the Commission * * * shall find that any rate * * * is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate * * * to be thereafter observed and in force, and shall fix the same by order."

325). Petitioners Wisconsin and New York do not insist that the Commission was compelled to decide the case on the basis of the existing record. They contend, rather (No. 72, Pet. 24), that "a supplemental hearing, to compare Phillips' present revenues with its present costs, should be held." The Eastern Seaboard companies appear to agree that the record should be "augmented if necessary" (No. 74, Pet. 4). Nor would the dissent in the court below require the fixing of rates on the record as it stands. Judge Fahy speaks (R. 429–430) of "decisions on the present record, supplemented as may be found to be reasonably necessary." It is only California which would require that rates for the future be fixed on the basis of a test year which is now eight years old.

The question therefore comes down to this: Was the Commission obliged to devote its energies and those of its limited staff to constructing a new record in order that a determination might be made on the basis of a rate-making technique found to be basically unsuited to this purpose, or was it free to concentrate its efforts upon the development of a new technique deemed appropriate to the task?

2. *The Commission is pursuing a vigorous and effective program of interim rate regulation and has succeeded in arresting the upward trend in natural gas prices*

Petitioners' contention that the Commission abused its discretion in declining to reopen these proceedings and develop a new record based upon an up-to-date test year rests on mistaken assumptions: that the only alternative was a hiatus in regulation; that the Com-

mission has abdicated its function for an indefinite period; and that the consumer, as a consequence, faces the prospect of a continuing increase in the price he pays for natural gas. The facts are, however, that the Commission is following a vigorous and effective program of regulation during this interim period; that its decision in this case is not preventing effective disposition of other cases; that the rising trend in the price of natural gas has been arrested; and that to follow the course petitioners demand (*i.e.*, to reopen the proceedings) would tend to interrupt and delay the program now being pursued.

(*a*) *The Commission has arrested the upward trend in producer prices.*—In their brief in the court of appeals, the Eastern Seaboard Companies presented a graph showing the upward trend of natural gas prices from 1953 through 1960 and projecting the past increase through 1969.[15] The prognosis was that by 1969 the price of natural gas at the wellhead might be expected to approximate 30¢ per Mcf, or about double the 1960 figure.

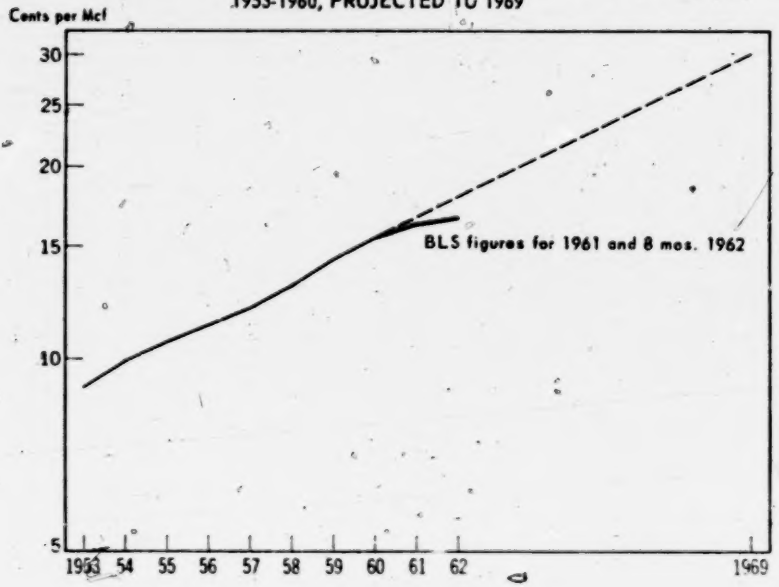
The fact is that since the Commission's decision in this case the rate of increase in natural gas prices has fallen off sharply. Indeed, the average price per Mcf for natural gas as of August 31, 1962 (16.36¢) was actually lower than it had been a year earlier (16.46¢), although the average for the entire twelve-month period ending August 31, 1962, was still slightly above

[15] The figures underlying the chart are those published by the Federal Power Commission for the earlier years and by the Bureau of Labor Statistics in the later years covered.

the average for the preceding twelve-month period (16.52¢ against 16.12¢).[19]

We reproduce the Eastern Seaboard Companies' chart here, with additions showing the Bureau of Labor Statistics figures for 1961 and the first eight months of 1962.

AVERAGE PRICE OF NATURAL GAS PAID BY INTERSTATE PIPELINE COMPANIES, 1953-1960, PROJECTED TO 1969

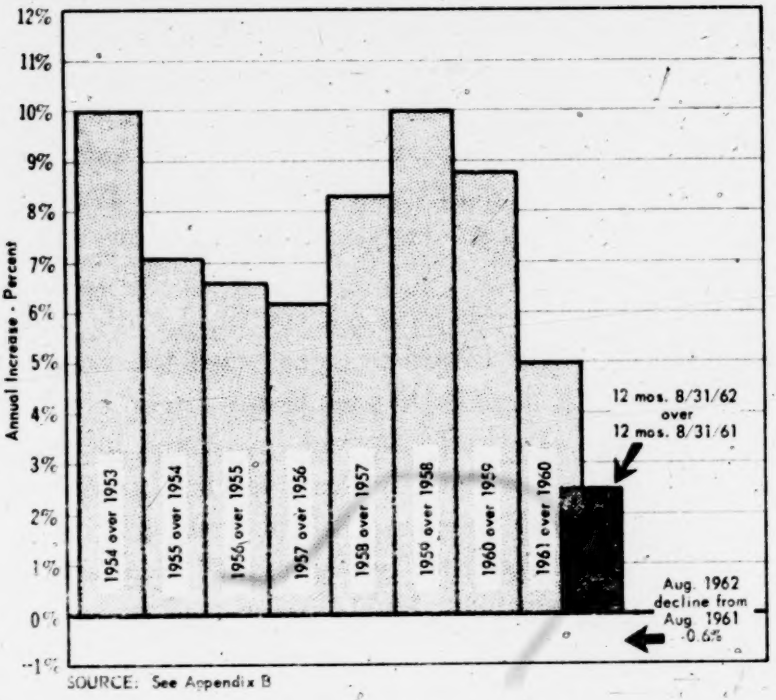


It is apparent that the trend is contrary to petitioners' predictions. Their chart showed an average increase of over 8% per annum up to and including 1960. The 1959 price level was 10% above the previous year and the rate of increase declined only slightly in 1960. The 1961 price, however, rose only 5% and the average price for the twelve months

[19] The sources for these figures, and for the figures on which the charts on pp. 34 and 35 are based, are shown in Appendix B, *infra*.

ended August 31, 1962, was but 2.5% above that for the preceding twelve-month period. And, as we have noted, the price in August 1962 was lower than that in August 1961.[19a] These figures are shown in the following chart:

PERCENTAGE INCREASES IN PRICE OF NATURAL GAS



SOURCE: See Appendix B

(b) *Changes in "policy statement" prices reflect an active regulatory program.*—The Commission has employed several means to achieve greater stability in

[19a] Since receiving the page proof of this brief, we have learned that the September 1962 figure is 16.72¢, and are informally advised that preliminary indications are that October will show a decline. The average for the 12 months ended September 30, 1962, was 16.54¢ compared with 16.16¢ in the previous 12 months, a rise of 2.4%.

wellhead prices. In the first place, simultaneously with its decision in the case at bar, it issued Statement of General Policy No. 61–1. That statement promulgated two ceiling prices for all the major producing areas of the country. The first ceiling (sometimes called the "new gas" ceiling) was designed to be used, and is being used, as a limitation on the prices at which the Commission grants certificates for new sales of gas (or for construction of pipeline facilities contemplating such "initial" sales) in the respective areas. The second ceiling price (sometimes called the "old gas" ceiling) marks the point at which the Commission will suspend proposed rate increases under existing contracts.

These ceiling levels have not remained static. New developments and information have led the Commission to modify them from time to time in an effort to achieve more reasonable current prices and increased assurance of price stability in the future. In the important South Louisiana area, the ceiling price for new gas was reduced last year, from 21.5¢ *plus* State taxes of 2.3¢ per Mcf to 21.25¢ *inclusive* of State taxes for gas subject to State taxes, and to 19.5¢ for gas taken from the off-shore federal domain.[20] Thus, the reduction for State-taxed gas was 2.55¢ per Mcf and for other gas 2¢ per Mcf, or a decrease in the range of 10%.

[20] Fourth Amendment to Statement of General Policy No. 61–1, issued October 31, 1961. The differential of 1.75¢ between the price of gas subject and not subject to State tax was fixed at less than the amount of the tax in order to encourage exploration for gas in the off-shore areas outside the State's jurisdiction.

In seven Texas districts, the ceilings for increased rates (*i.e.*, the "old gas" ceilings) were raised slightly (0.5¢ to 1¢).[21] As to three of these, the Commission corrected its earlier failure to include in the price an allowance for State taxes (all area ceilings are inclusive of such taxes), while in the other four the increased ceilings applied only where the producer, in proposing a price increase, agreed at the same time to eliminate from his contract certain provisions for price increases in the future.

By its most recent amendment to the Policy Statement,[22] the Commission reduced the price ceiling for initial sales from 18¢ to 16¢ in Texas District No. 4. This action was the result of reexamination of the facts in the light of present conditions, as revealed in a certificate case, *Skelly Oil Co., infra,* p. 39, nofe 26.

(*c*) *Stable prices at lower levels have been achieved in numerous important cases.*—The Commission has achieved lower current prices and greater assurance of price stability by its disposition of individual certificate cases (under Section 7) and rate proceedings (under Section 4 and Section 5). The Commission's files show that from September 30, 1960 to June 30, 1962, the Commission issued 2,880 temporary authorizations under Section 7. Of these, 684 were issued with price conditions, most of which brought the pro-

[21] Second and Third Amendments to Statement of General Policy 61-1, dated December 20, 1960 and March 29, 1961, respectively.

[22] Fifth Amendment to Statement of General Policy 61-1, dated August 30, 1962.

posed initial price down to the area ceiling.[23] In the other 2,196 cases, the proposed initial price was at or below the ceiling. In 31 cases, the temporary authorizations were superseded by permanent certificates under which the producer applicant reduced the proposed initial price to the ceiling price.

Numerous permanent certificate cases show substantial price reductions imposed by the present Commission, some of them in accordance with earlier court remands. For example, the *Catco* case[24] was remanded to the Commission on the ground that the proposed initial price of 21.4¢ per Mcf was not shown to be required by the public convenience and necessity. Upon reconsideration in the light of this Court's opinion, the Commission fixed a price of 18.5¢. *Continental Oil Co.*, 27 F.P.C. —, Opinion No. 351, Docket Nos. 11024, *et al.*, January 22, 1962, rehearing denied March 22, 1962, 27 F.P.C. —.

Similarly, on July 30 and August 24, 1962, the Commission approved settlements of 53 certificate applications in South Louisiana.[25] The prices were reduced from the 21¢–24¢ range to 19¢ for gas produced from the off-shore federal domain and 20.625¢

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[23] In a small number of cases the proposed initial price was permitted to be collected subject to refund—a practice which has been discontinued—and in another small group of cases the producers were permitted to collect a price which exceeded the area ceiling by an amount which reflected the above-normal heating value of the gas (the "B.t.u. adjustment"), subject to refund of the excess if subsequent proceedings justify a refund.

[24] *Atlantic Refining Co. v. Public Service Commission of New York*, 360 U.S. 378.

[25] F.P.C. Release No. 12140, *Texaco Inc., et al.*, Docket Nos. G–13169, *et al.*, and F.P.C. Release No. 12183, *Socony-Mobil Oil Company Inc. et al.*, Docket Nos. G–13746, *et al.*

for on-shore gas subject to State taxes. Refunds of over $5,800,000 were provided, and the annual reduction in cost of gas to the three pipeline purchasers was over $3,000,000. In addition, provision was made for moratoriums on future price increases.

In *Skelly Oil Company*, Docket No. G–18638,[26] the Commission reduced to 15¢ the price for 31 sales of gas in Texas District No. 4, where the producers had asked for prices ranging up to 18¢. This proceeding resulted in the reduction in the Policy Statement price, as noted *supra*, p. 37.

In rate cases, too, the Commission has been active in reducing prices and assuring future price stability, as the recent Shell, Ohio Oil and Tidewater settlements[27] demonstrate. The first of these covers virtually all of Shell's rate schedules other than those under review in the current Permian Basin area rate hearings and those involved in pending show-cause or certificate proceedings. The approved price levels are all at or below the Policy Statement levels except for two schedules where special factual circumstances obtain. Refunds amount to $8.7 million and rates are reduced by $7.2 million annually. Among the most important provisions of the settlement is the company's agreement not to file rate increases until 1965 and, with respect to 12 rate schedules, until 1972.

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[26] Commission Opinion 362, August 30, 1962, rehearing granted, October 26, 1962 (mimeo.).

[27] *Shell Oil Co.*, Docket No. G–9446, order, August 1, 1962; *The Ohio Oil Co.*, Docket No. RI60–92, order, June 28, 1962; *Tidewater Oil Co.*, Docket No. G–13310, orders, June 15 and July 11, 1962. These orders have not yet been reported but are available in mimeographed form.

For certain schedules, rate increases are limited to 1¢ per Mcf every five years.

New York and the Eastern Seaboard Companies, which intervened, made no objection to the Shell settlement. California, which objected only on the ground that the Commission should have fixed just and reasonable rates for the few schedules eliminated from the settlement, did not seek rehearing and thus abandoned even that objection. Nonetheless, New York, which made no objection at the appropriate time, bitterly criticizes the similar Tidewater settlement in its brief (No. 72, Br., p. 35), claiming that it concurred only "to end the matter and attain some stability in gas costs (and relief from high Section 4(e) rates)." We submit that settlements which successfully accomplish these results can scarcely be cited as evidence of regulatory hiatus.

All of the foregoing settlements leave open the question of further adjustment of rates on the basis of the pending area rate hearings; that is, nothing in the settlement precludes any action which may be taken in the area proceedings.

Moreover, the Commission has ordered prompt hearings in Section 4(e) proceedings involving increased rates which exceed the Policy Statement levels and which, if not acted on prior to the end of the suspension period, would trigger similar filings by other producers (by operation of favored-nation or price redetermination clauses in their contracts). Thus, the Commission, in June 1962, suspended and set for expedited hearing increased rate filings (in the 25¢ per Mcf range) for sales in South Louisiana in order that

decision in the proceedings could be made prior to expiration of the suspension period.[28] In two other instances, the Commission has similarly adopted the expedient of an accelerated hearing. In each instance, the increased rate filings were either withdrawn[29] or were disallowed.[30]

Even more recently in *Hunt Oil Company*, Opinion No. 365, issued October 17, 1962, the Commission remanded Section 4(e) proceedings for the taking of additional evidence on the reasonableness of that producer's rate increases. The case is one in which a relatively minor supplementation of the record is required. In taking this action the Commission explained (slip. op., p. 5):

> * * * Cost-of-service was the method which was used in this proceeding and others pending before the Commission prior to the commencement of the area rate proceedings and, as we have previously indicated, we intend to continue to process and decide such proceedings as promptly as the record in each case permits. * * *

At the same time, the Commission, consistently with its approach in the instant case, refrained from pursuing the Section 5(a) proceeding against the company. In this connection, it stated (*id.*, p. 6):

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[28] *H. L. Hunt, et al.*, Docket Nos. RI62-467, et al., order issued June 29, 1962 (unreported).

[29] *Humble Oil & Refining Company, et al.*, Docket Nos. RI61-132, et al., order issued February 14, 1961 (unreported). Phillips was one of the companies filing an increased rate and withdrawing the same.

[30] *Union Producing Company*, 24 F.P.C. 841, Docket No. RI60-435.

> The Section 5(a) aspect of the proceedings is in a different posture. There are currently pending area rate proceedings in the Permian Basin and Southern Louisiana in which a large percentage of Hunt's jurisdictional sales are the subject of investigations pursuant to Section 5(a). It is our hope that area proceedings will result in a timely determination of Hunt's rates for the future. * * *

Significantly, most of the cases discussed above (*supra*, pp. 38–40) involve rates in South Louisiana where petitioners have charged that the Commission has allowed prices to run wild. The Eastern Seaboard Companies (No. 74, Br. p. 23), refer to South Louisiana as "the most important example" of an area where the Commission has exercised little or no effective price regulation, and state (*id.*, App. D–2) that 13 major producers sold 436 million Mcf subject to Commission jurisdiction at prices above the 21.25¢ initial price ceiling in that area in 1960, and that 134 million Mcf of that volume was not subject to refund. These figures are both erroneous and out of date.

As explained in Appendix C, *infra*, pp. 69–70, the 13 producers actually had 399 million Mcf of jurisdictional sales in 1960 at prices higher than the 21.25¢ ceiling, and only 44 million of that total was not subject to refund. For Phillips alone, the amount of such sales not subject to refund was 4,723,411 Mcf (less than 1% of its sales), instead of the 23,950,166 claimed by petitioner. Since then, the settlements described above have reduced to a figure at or below the ceiling prices for 155 million Mcf of the above-ceiling jurisdictional sales by these 13 producers.

This leaves 244 million of 1960 jurisdictional sales at prices above 21.25¢, and of those only 30 million Mcf are not subject to refund (*i.e.*, 12% of the total, instead of 31% of a total almost twice as large, claimed by petitioners).

The Eastern Seaboard Companies acknowledge (Br., p. 24, fn. 9) that their figures "may overstate" the amount of jurisdictional revenues not subject to refund, but it seems clear that their Appendix D-2 is valueless even as an approximation. Their Appendix D-1 is also subject to grave infirmities, the magnitude of which we cannot estimate. It includes large volumes of non-jurisdictional purchases. Its caption refers to "Prices Paid for Natural Gas by Interstate pipelines," but the fact that those pipelines make many non-jurisdictional purchases does not appear. Indeed, the annual reports of the pipeline companies to the Commission (FPC "Form 2" reports), on which the table is based, show this to be the fact. Thus, insofar as the claim of the Commission's failure to regulate gas prices rests on Appendix D-1, it is based in substantial part on transactions over which the Commission has no control.

In sum, not only has the rising trend of prices of natural gas at the wellhead been largely leveled off during the two years since the Commission decision here under review, but resolution of the important cases discussed above indicate that in the last few months the trend of prices in South Louisiana, about which petitioners express so much concern, has been downward instead of upward. Furthermore, the moratoriums in the settlement agreements, which

could not have been imposed by Commission order, provide effective limitations on price increases in the future.

3. The remand sought by petitioners would cause, rather than cure, delay in the regulatory program

As we have seen, all of the petitioners (except California, which insists that the rates should have been prescribed on the basis of the 1954 test year) argue that the Commission was obliged to reopen the record in order to obtain an up-to-date cost showing. In addition, the Eastern Seaboard Companies urge that the Commission should similarly bring to a conclusion several other Section 5(a) proceedings which were instituted prior to its decision here and in which hearings have been completed (No. 74, Br. 26–27, and Appendix A at p. 33). However, if the Commission, in 1960, had assigned its limited staff the task of compiling a new record in the *Phillips* case, and also completing (and in some instances updating the record in) the twenty or more other Section 5(a) proceedings then pending,[31] it certainly could not have proceeded vigorously with its new regulatory program and doubtless would have been obliged to postpone the launching of the area rate proceedings now under way—proceedings which, in its view, offer the only real promise of effective and comprehensive regulation.

The Commission must necessarily have broad discretion in determining priorities among competing regulatory activities. *Federal Communications Com-*

[31] See brief of Eastern Seaboard Companies in No. 74, Appendix A, p. 33.

mission v. *WJR, The Goodwill Station*, 337 U.S. 265. That discretion was properly exercised here when, expressly rejecting the contention that the record should be brought up to date, the Commission stated (R. 397):

> * * * For the future it is our judgment that the interest of consumers and the exigencies of regulation will be better served in rate proceedings brought on an area basis rather than on an individual company basis. Therefore, we do not think it in the public interest to reopen these proceedings, to determine a cost of service on the basis of completely new evidence and to attempt to determine rates on the basis of Phillips' individual cost of service.

It is clear, moreover, that a decision by this Court, the effect of which is to require the Commission to reopen the records in this and all other unsettled Section 5(a) cases in which hearings have been completed, would necessarily tend to delay area rate proceedings. At present, as is shown by Appendix A of the brief of the Eastern Seaboard Companies, there are eleven outstanding Section 5(a) proceedings (including this case) in which hearings have been completed and four in which the examiner's decision has been rendered. In virtually all of these cases, the record was based on a test year now four to seven years old. If the *Phillips* case alone were to be remanded to the examiner with directions to obtain a new record based upon an up-to-date test year, the ultimate Commission decision would probably be a year away. To be sure, some of the major principles which would be applied

to the new cost data submitted by the parties have already been decided by the Commission's decision here under review. But new issues might be expected to arise in relation to the special circumstances of the new test year, and, in any event, the preparation of cost-of-service exhibits by Phillips, and of responsive exhibits by the other parties, would in itself consume many months. Thus, assuming this Court's decision—by hypothesis, adverse to the Commission—were handed down in the first quarter of 1963, the final rate determination could not be anticipated much earlier than the first quarter of 1964. And to require the assignment of that portion of the Commission's staff which is available for producer rate cases to determining rates by the old method in this and other Section 5(a) proceedings, would seriously impede the area rate program.

Petitioners suggest that area proceedings in all of the producing areas may not be completed for a great many years, with estimates ranging up to fourteen years (No. 74, Br., p. 15). We do not underestimate the magnitude of the task which confronts the Commission, particularly while the new approach is still in its formulative stage, but believe that these extreme estimates are highly unrealistic. The Eastern Seaboard Companies refer to testimony of Joseph C. Swidler, Chairman of the Federal Power Commission, before a subcommittee of the House Appropriations Committee on February 26, 1962 (No. 74, Br., pp. 13–14), in which Chairman Swidler declared, among other things, that it "will take a year or two probably

before we could hope to come out with the answer in the *Permian Basin* case." Even if one accepts the more cautious two-year estimate, this pioneering case would be concluded by the early part of 1964, no later than the anticipated decision-date in the instant case if it were remanded by this Court (see *supra*, p. 45). Moreover, after the basic regulatory patterns have been established in the pilot area-rate cases (*Permian Basin* and *South Louisiana*), the Commission should be able to conduct and conclude other area proceedings with greater speed.

We also point out that approximately 35% of the gas sold by Phillips under its jurisdictional rate schedules is produced in the Permian Basin, and another 7% in South Louisiana,[32] the two areas in which area-rate proceedings are already in progress. It would appear, therefore, that area-rate determinations governing a substantial portion of Phillips' sales *and sales of many other major producers as well* may be available within roughly the same period that it would take to complete a Section 5(a) proceeding covering Phillips alone.

Certainly, it is clear that the Commission cannot effectively pursue both objectives at the same time. It cannot make optimum progress in establishing area rates if simultaneously it must also establish individual company rates according to the rate-base technique it found wanting. It cannot fix rates for the industry as a whole if it must continue, company-by-company, to undertake the kind of proceeding to

[32] Calculated from Phillips' Annual Report to the Federal Power Commission (FPC Form 301) for 1960.

which the Court referred when it noted that "* * * the delay incident to determination in § 5 proceedings * * * appears nigh interminable." *Atlantic Refining Co.* v. *Public Service Commission of New York*, 360 U.S. 378, 389. Granting that there are problems of transition, it should not be compelled to expend its necessarily limited capacities in travelling two divergent roads leading to inconsistent ends. As the Court of Appeals for the District of Columbia Circuit observed in *United Air Lines* v. *Civil Aeronautics Board*, 228 F. 2d 13, 16:

> * * * the problem of administration of its own business is singularly within the Board's prerogative. As an informed body it must have wide scope in its administration of the business committed to its charge. * * *

II. TERMINATION OF THE SECTION 4(e) PROCEEDINGS WAS APPROPRIATE IN THE CIRCUMSTANCES OF THIS CASE

With one minor exception,[33] all of the rates involved in the Section 4(e) dockets have been superseded by subsequent increases which the Commission has suspended in other proceedings. These rates, therefore, have no current or future significance. The only issue is whether refunds should have been ordered for the periods during which they were in effect.[34]

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[33] Docket No. G-8623, involving an increase of $21,324 annually.

[34] The positions of petitioners with respect to the Section 4(e) proceedings have varied considerably. Neither New York nor California complained of the terminations in the court below. The Eastern Seaboard Companies objected to the Commission's failure to make findings of justness and reason-

As noted *supra*, p. 8, Phillips' indicated total revenue requirement for 1954 was $59,725,315, or 12.16¢ per Mcf (after adjustments). Its test year jurisdictional revenues were $45,568,291. The rate increases involved in these Section 4(e) filings amount to $5¼ million (R. 75), or only about 37% of the deficiency. It was on this basis, *i.e.*, that the rates in question fell far short of the cost of service, that the Section 4(e) proceedings were terminated and Phillips' refund obligation discharged.

Petitioners accept the Commission's findings,[35] but argue (No. 72, Br. p. 45) that the termination of the Section 4(e) proceedings was erroneous because:

> * * * it permits Phillips to retain the $5.3 million increase for each year during the period 1955–1959. If we could assume that Phillips' revenues remained constant during the 1954–1959 period, then the Commission's treatment insofar as it related to level of revenue would be eminently correct. But in point of fact, Phillips' revenues did not remain constant; as the result of additional sales volumes, increased rates for old sales, and new sales at higher prices, revenues virtually doubled.

This is essentially an argument that the record was stale and should have been reopened to allow petitioners to show that at a later stage revenues exceeded costs. But neither before the Commission nor in the

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ableness, while Wisconsin, which was the only party to challenge the Commission's cost-of-service figures in the court below, has abandoned that challenge here.

[35] See note 34, *supra*.

courts have petitioners shown that the Commission abused its discretion in failing to follow this course. See *Interstate Commerce Commission* v. *Jersey City*, 322 U.S. 503, 514–517, and cases there cited.

Specifically there is no showing here that the 1954 record was not reasonably applicable to the 1955–59 period (during which the vast majority of the increased rates were in effect) for purposes of determining whether refunds were due. The fact that Phillips' revenues "virtually doubled" during that period proves nothing in itself—its volumes had increased. The same table of figures on which Wisconsin and New York rely (Br., p. 24), to show the revenue increase shows also—and no less importantly—the average revenue per Mcf in each year. Those averages are as follows:

1955	1956	1957	1958	1959
8.9¢	9.4¢	9.9¢	11.1¢	12.3¢

When it is recalled that Phillips' test year revenue requirements were 12.16¢ per Mcf, the claimed increase in revenues falls into proper perspective. Even if we assume that Phillips' unit costs did not increase during that period of generally rising wages, deeper drilling, higher purchased gas costs, etc., there is still no showing that 1954 was not an appropriate basis for deciding the question of refunds for the 1955–1959 period. It was only for purposes of future rate-making under Section 5(a), i.e., for years subsequent to 1960, that the 1954 figures were obsolete.

It was only in those years that the company's average rate went beyond the 12¢ range.

Petitioners make two further arguments. The first is that the Commission, though deciding that no refunds were necessary, failed to make the finding that the rates involved in the Section 4(e) proceedings were just and reasonable. This claim is pointedly answered by the opinion of the court below (R. 420):

> * * * The contention is that the Commission made no decision. We think the point is not well taken. The Commission did make a clear decision, after elaborate findings, upon the one substantive issue before it. It did say it "terminated" the proceedings, but it terminated them after deciding the basic and dispositive issue, and it entered an order on that decision. Its "termination" was much like that of a judge after he has rendered findings, conclusion and judgment.
>
> Whether the Commission should have preceded its ultimate conclusion of no-refund with an intermediate conclusion of justness and reasonableness in the rates at issue, and whether it properly added the termination order to its decisive finding, seem to us to be immaterial queries. The important feature is that the Commission reached and decided the critical substantial issue, rationally and upon detailed findings of basic facts upon an ample record.

The Commission's finding on that dispositive issue—based upon a subsidiary finding, undisputed here, as to Phillips' cost of service for the test year 1954 [36]—

[36] A 1956 study submitted by Phillips indicated, moreover, that "cost of service for that year was not very different from 1954" (R. 272).

was that "* * * these rates have produced revenues less than Phillips' cost of service during the periods that they were in effect" (R. 325–326). By this finding, the Commission laid to rest the only question presented in these Section 4(e) dockets.

The sole remaining argument is that there were differences in the rates involved in the various Section 4(e) proceedings, with some of them above and some below the average cost of service. New York (which has not previously attacked the Section 4(e) terminations) and Wisconsin (which has not previously claimed that Phillips' rates are discriminatory) now claim (No. 72, Br. pp. 45–46) that since seven of the twelve rates in question exceeded the average cost of service, the Commission should have found that "this pattern of rate differentials constituted undue discrimination or preference."

This point, to begin with, is not properly here, not having been raised below or presented to the Commission. Although Wisconsin argued in its application for rehearing that some of the rates were improper because they exceeded the cost of service (R. 360), none of the petitioners urged that the rates were discriminatory. It is well settled that parties are precluded by Section 19(b) of the Act from raising before the courts a point which they failed to raise before the Commission itself. *Panhandle Eastern Pipe Line Co.* v. *Federal Power Commission*, 324 U.S. 635, 647, 650–651; *Federal Power Commission* v. *Colorado Interstate Gas Co.*, 348 U.S. 492; *Sunray Mid-Continent Oil Co.* v. *Federal Power Commission*, 364 U.S. 137, 157.

In any event, the charge of discrimination is not supported. Sections 4(b) and 5(a) of the Act forbid rates which are unduly discriminatory or preferential, but mere differences in rates are not *per se* illegal; it must appear that they are not justified by the costs of the respective services, by their values, or by other conditions. *United States* v. *Illinois Central R.R. Co.*, 263 U.S. 515, 524. The mere fact that some rates exceed the average cost-of-service, or may be higher than the rates for other gas produced and sold by the same company in different areas and under different circumstances, does not render them unduly discriminatory or preferential, and the Commission found (R. 325) that nothing in the record showed these rates to be so. No party is contending, or reasonably could contend, that there is any evidence in the record which would enable the Commission to allocate cost of service rate by rate, or otherwise make a finding of discrimination.[37] Absent a showing that the gas sold under the various rate schedules is produced under similar conditions, is of similar quality, and is sold in similar markets in similar quantities under contracts negotiated at roughly the same time, a claim of discrimination based solely on price differences is wholly insubstantial.

[37] Unlike the *Hunt* case, *supra*, p. 41, where the Commission directed the examiner to take evidence on discrimination between rates, the Section 4(e) rates in the case at bar have no current or future applicability and are uniformly below the "new gas" ceilings in the respective areas. Consequently the Section 4(e) rates here can have no impact on the level of prices.

III. CALIFORNIA'S ARGUMENTS ON SPIRAL ESCALATION CLAUSES ARE NOT PROPERLY RAISED AND IN ANY EVENT LACK MERIT

California contends that the Commission erred in refusing to reject the proposed rate increases based upon "spiral escalation clauses" in three of Phillips' contracts (No. 73, Br. pp. 56–61).[38]

This argument relates to three of the twelve Section 4(e) dockets Nos. G–11217, G–10883 and G–10793. As to the first two dockets, it is premature. As to the third, California lacks standing to complain. And, as to all three, the contention is without merit. We first discuss the question of prematurity.

1. The spiral escalation clauses, as explained *supra*, p. 9, fn. 9, provide that whenever a specified commodity price increase (*e.g.*, the Bureau of Labor Statistics wholesale price index) shall have risen by a prescribed number of points and a general increase in the pipeline customer's rates shall have been instituted, the Phillips' rates to the customer shall be increased proportionately. Rate increases based upon such clauses, like any other increases filed with the Commission, may be suspended under Section 4(e) and made subject to refund.

Two of the three Section 4(e) dockets in which the contracts contained such clauses—Nos. G–11217 and G–10883—were not terminated by the Commission. See ordering paragraphs (B) and (C) of the Commission's order, R. 332. As to these, no final order

[38] Wisconsin has apparently abandoned in this Court the attack which it made below with respect to spiral escalation clauses.

has been issued and the review here sought is premature. The reason no final order was made is that El Paso and Panhandle Eastern, the pipeline purchasers of the gas sold under the schedules involved in those dockets, argued that the increases were dependent on the operation of spiral escalation clauses in their own resale contracts, which were then under consideration in other dockets (G–4769 and G–2506). Since the amount of permissible increases in the latter dockets, which related to the rates charged by the pipelines, had not been decided, the effect of these increases on Phillips' rates by virtue of the spiral escalation clauses in its contracts could not yet be determined in the Phillips hearings.

Section 19(b) of the Natural Gas Act limits the right of review to parties who are "aggrieved" by an "order" of the Commission. The order here under review does not determine the amount of the rate increase, if any, that will be allowed in either of these two dockets. It leaves them open for further administrative action. Plainly, if the final order results in disallowance of the proposed increases, neither California nor anyone else (except, perhaps, Phillips) will be aggrieved. For that reason, California's attack is premature, and the Commission's action with respect to these two dockets is not properly before the courts. *Northwestern Electric Co. v. Federal Power Commission*, 125 F. 2d 882, 887 (C.A. 9), citing *Federal Power Commission v. Metropolitan Edison Co.*, 304 U.S. 375, 383. See also *California Oregon Power Co. v. Federal Power Commission*, 239 F. 2d 426, 433 (C.A.D.C.).

2. In Docket No. G–10793 there was no contention that the escalation clause had not become effective according to its terms. Since the decision in that docket did not depend on the decision in any pipeline rate docket, G–10793 was among those in which proceedings were terminated. However, the only party affected by that termination is Wisconsin, which no longer attacks it.

California's asserted interest in the operation of spiral escalation clauses derives from the fact that "the price of natural gas to the California consumer is largely dependent upon the rates set by the [Federal Power] Commission for the sale of gas by [El Paso Natural Gas Company, a pipeline] for resale in California. These rates, in turn, are dependent to a great extent upon the cost to El Paso of natural gas purchased by it from Phillips" (No. 73, Br. p. 57). But Docket No. G–10793 does not involve a sale to El Paso or any other California supplier. Instead, it relates to a sale in Hansford County, Texas, by Phillips to Michigan-Wisconsin Pipe Line. Wisconsin, which is supplied by this customer of Phillips, has evidently not considered this sale, made in 1956 [39] at a price of 10.858¢ per Mcf and since superseded, to be sufficiently important to warrant raising this question here. California has not alleged and, we believe, could not show that it is in any way affected by Phillips' price for this sale. No claim of financial loss to any citizen of California is made. The only claim made is that spiral escalation clauses in general

[39] Filed June 25, 1956, as Supplement No. 19 to Phillips' F.P.C. Gas Rate Schedule No. 4.

are "derogatory of the public interest and void in this regulatory setting."[40]

We do not question the right of a State to attack a Commission order that affects its citizens adversely. But States are not the guardians of one another's citizens. To allow California to attack an order which has no impact on anyone California represents would require an unwarranted extension of the concept of aggrievement. The courts have consistently declined to go so far. See, *e.g.*, *United States Cane Sugar Refiners' Ass'n.* v. *McNutt*, 138 F. 2d 116 (C.A. 2). The plain language of section 19(b) of the Natural Gas Act requires aggrievement before suit can be brought, and aggrievement involves, at the very minimum, some adverse effect. California lacks standing to challenge the Commission's disposition of a docket involving no interest of California.

3. In any event, the Commission's conclusion that a spiral escalation clause provides adequate authority for the filing of an increased rate, which thereupon becomes subject to the provisions of Section 4 of the Act, is correct on the merits. Admittedly, as California points out, the Commission, in the period subsequent to its decision in this case, has promulgated a series of rule-making orders condemning spiral escalation clauses and other so-called "indefinite" price-changing provisions,[41] as against the public interest. By Orders Nos. 232 [25 FPC 379, 26 F.R. 1983 (1961)]

[40] No. 72, Br., p. 56.

[41] Certain designated types of price-changing provisions are permitted by the orders cited in the text, *e.g.*, provisions that change a price to a specific amount at a definite date.

and 232-A [25 FPC 609, 26 F.R. 2850 (1961)], it announced that such clauses, where contained in contracts executed on or after April 3, 1961, would thereafter be held to be without effect. By Order No. 242 [27 FPC —, 27 F.R. 1356 (1962)], it announced that contracts containing such clauses would be unacceptable for filing after April 2, 1962. Those orders, however, are exclusively prospective in their application, and they do not purport to govern contracts executed prior to April 3, 1961. In its 1960 decision here, the Commission noted that while "we do not approve of such clauses in principle, there is not sufficient basis on this record to hold them so derogatory of the public interest as to be void as a matter of law." (R. 327). The three contracts which contain the spiral escalation clauses involved here are dated 1943, 1945, and 1953 (No. 73, Br., App., pp. 14–17). All of them, therefore, were consummated not only before the Commission's recent orders outlawing spiral escalation clauses for the future, but even before the Commission began regulating independent natural gas producers under this Court's 1954 decision in the instant case (347 U.S. 672).

California insists, nonetheless, that if spiral escalation clauses have now been found by the Commission to be incompatible with the public interest, they should be struck down even when contained in contracts executed prior to April 3, 1961. The complaint here, it should be emphasized, is not that the Commission failed to render Phillips' spiral escalation clauses inoperative for the future. As to the prospective operation of such clauses, the Commission

concluded that (R. 327) "We need not require that they be eliminated, since Phillips has already agreed to do so." No party disputes this conclusion. Rather, the contention is that the Commission should have treated the spiral clauses as void *ab initio*. In that event, the clauses would not have constituted valid contractual consents by the buyers to the filing of Phillips' increased rates in these three dockets and, absent such consent, those filings would now have to be rejected retroactively as nullities, regardless of whether the rates collected under them were just and reasonable in relation to the company's cost of service. See *United Gas Pipe Line Co.* v. *Mobile Gas Service Corp.*, 350 U.S. 332.

In effect, California is arguing that the Commission was not only free, in the exercise of its experienced judgment, to nullify spiral escalation clauses, but that it was legally compelled to do so, and, moreover, to do so on a retroactive basis even with respect to contracts executed long before the Commission's action. We submit that this extreme position is wholly unreasonable. California makes no showing that when these contracts were made (as far back as 1943) it was contrary to the public interest for producers, who were then selling gas at extremely low prices, to negotiate provisions calling for increases proportionate to those received by their customers. In any event, until the Commission adopted its prospective orders in 1961 and 1962, there was no statute, common-law rule or administrative regulation which compelled or even invited the conclusion that these spiral provisions were

void as a matter of law."[42] Courts of appeals, when called upon to review such provisions, never suggested that rate increases filed pursuant to them had to be rejected. *Phillips Petroleum Co.* v. *Federal Power Commission*, 227 F. 2d 470 (C.A. 10), certiorari denied *sub nom. Michigan Wisconsin Pipe Line Co.* v. *Phillips Petroleum Co.*, 350 U.S. 1005; *Kerr-McGee Oil Industries, Inc.* v. *Federal Power Commission*, 260 F. 2d 602 (C.A. 10). Indeed, this Court itself sustained the right of a seller to file an increase under a contract which authorized him, in effect, to file such increases *ad libitum*. *United Gas Pipe Line Co.* v. *Memphis Light, Gas and Water Division*, 358 U.S. 103. If a contract which places no limitation whatever on the seller's right to file is not invalid, absent a statute or regulation making it so, then neither, we submit, is one which is limited by the provisions of a spiral escalation clause.

If the Commission acted reasonably in 1960 when it refused to strike down the spiral clauses in Phillips' contracts, its action certainly did not become unreason-

[42] California places mistaken reliance on language in a 1954 Commission opinion, *Michigan-Wisconsin Pipe Line Co.*, 13 F.P.C. 326. The Commission there was considering the cost to the pipeline of gas purchased from Phillips. Those claimed costs included increases based on escalation clauses which had not yet become effective. The Commission there held, and properly so, that the mere existence of the spiral clauses could not be treated as triggering a rise in the pipeline's costs, because any rate increases Phillips might file pursuant to those clauses would be subject to Commission review under § 4(e) before becoming effective. In the meantime, the pipeline's costs were to be measured by Phillips' presently filed rates.

able merely because it later saw fit to issue orders banning such provisions for the future. To hold otherwise would be to say that the Commission had no choice but to make those orders retroactively applicable to contracts, and also to rate filings, prior to April 3, 1961. There is ample justification, however, for the Commission's decision to restrict its policy to future contracts. In the first place, if the Commission were to void all spiral escalation clauses, whenever executed (or if this Court, by its decision here, were to do so), it might well be inundated by rate filings of producers claiming, whether validly or otherwise, that the contracts were no longer in force and therefore no longer restrained them from filing for higher rates.

Moreover, by treating long-standing spiral escalation clauses as nullities, the Commission might be depriving Phillips and other producers of contract rights for which they bargained at a time when such clauses were not even remotely suspect on public policy grounds. Here, for example, the buyers' authorization for Phillips to file increases in accordance with the spiral clauses may have been consideration for Phillips' agreement to the original price. Had Phillips foreseen at the time it entered into these contracts that the spiral clauses might later be deemed void *ab initio*, it might have been able to insist upon a higher price for its gas or else to negotiate a type of price escalation clause which would not have fallen within the proscription of the Commission's subsequent or-

ders. Whether these considerations would bar the Commission from regulating spiral clauses on a retroactive basis is a question not presented here. It seems clear, however, that the Commission was not *obliged*, as a matter of law, to impose such harsh consequences upon Phillips. This Court refused to reach such a result in a similar situation involving a contract subject to regulation under the Interstate Commerce Act. *Southwestern Sugar & Molasses Co., Inc.* v. *River Terminals Corp.*, 360 U.S. 411. There the contract contained an inherently illegal condition, relieving respondent from liability for its own negligence, which was filed as part of a tariff with the Interstate Commerce Commission. A like clause in a contract not subject to I.C.C. control had previously been held void in *Bisso* v. *Inland Waterways Corp.*, 349 U.S. 85, on the ground that it was contrary to public policy. In the *Southwestern Sugar* case this Court said (360 U.S. at pp. 417–418):

> * * * For all we know, it may be that the rate specified in the relevant tariff is computed on the understanding that the exculpatory clause shall apply to relieve the towboat owner of the expense of insuring itself against liability for damage caused tows by the negligence of its servants, and is a reasonable rate so computed. If that were so, it might be hard to say that public policy demands that the two should at once have the benefit of a rate so computed and be able to repudiate the correlative obligation of procuring its own insurance with knowledge that the towboat may be required to respond in

damages for any injury caused by its negligence despite agreement to the contrary. For so long as the towboat's rates are at all times subject to regulatory control, prospectively and by way of reparation, the possibility of an overreaching whereby the towboat is at once able to exact high rates and deny the liabilities which transportation at such rates might be found fairly to impose upon it can be aborted by the action of the I.C.C. The rule of *Bisso*, however applicable where the towboat owner has "the power to drive hard bargains," may well call for modification when that power is effectively controlled by a pervasive regulatory scheme.

CONCLUSION

The basic question in this case concerns the permissible scope of the Commission's discretion when it is faced with a record which does not permit it to fix future rates. That question would not be worth the attention of this Court but for the extraordinary history of this case. We have shown that a termination of proceedings on this record was a reasonable exercise of discretion in the light of the regulatory program then set forth and now being implemented. A remand for the purpose of bringing the record up to date can only result in interference with that program and in the enforced use of a method which the Commission rejected for reasons which are legally sufficient, grounded in experience and plainly within the agency's special competence.

The judgment should be affirmed.
Respectfully submitted.

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APPENDIX A

The Natural Gas Act, Section 4(e), 15 U.S.C. 717c(e) and Section 5(a), 15 U.S.C. 717d(a), as amended, provides as follows:

SEC. 4. (e) Whenever any such new schedule is filed the Commission shall have authority, either upon complaint of any State, municipality, State commission, or gas distributing company [1a] or upon its own initiative without complaint, at once, and if it so orders, without answer or formal pleading by the natural-gas company, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the natural-gas company affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect; [1a] and after full hearings, either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made at the expiration of the suspension period, on motion of the natural-gas company making the filing, the proposed change of rate, charge, classification, or service shall go into effect. Where increased rates or charges are thus made effective, the Commission may, by order, require the natural-gas company to furnish a bond, to be approved by the Commission, to refund any

[1a] Subsection 4(e) was amended May 21, 1962, by Public Law 87-454, 87th Cong., 2d Sess. [S. 1595], 76 Stat. 72.

amounts ordered by the Commission, to keep accurate accounts in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts were paid, and, upon completion of the hearing and decision, to order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the natural-gas company, and the Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible. [52 Stat. 822 (1938); 76 Stat. 72 (1962); 15 U.S.C. § 717c]

SEC. 5. (a) Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: *Provided, however,* That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural-gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural-gas company: but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates.

APPENDIX B

Sources for Charts on Pages 34, 35.

The chart shown by the Eastern Seaboard Companies in their brief below is based on the following data, in cents per Mcf, as stated in footnote 31 on page 26 of that brief:

	1953	1954	1955	1956	1957	1958	1959	1960
FPC	9.0	9.9	10.6	11.3	12.0	13.0	14.3	
BLS						12.9	14.3	15.5

The "FPC" data for 1953–59 are as reported by the Commission in "Direct Sales by Producers of Natural Gas to Reporting Interstate Pipeline Companies." The "BLS" data for 1958–60 are as reported by the Bureau of Labor Statistics in its "Wholesale Prices and Price Indexes."

The following monthly figures showing the price paid by pipelines for natural gas for the period since the beginning of 1960 are also taken from the Bureau of Labor Statistics' "Wholesale Prices and Price Indexes." The prices for each month from January 1960 through August, 1962 are found as Series 05–31–01 in the monthly issues of that publication for February, 1960 through September, 1962, respectively. The BLS figures, which are reported in dollars per million cubic feet, have been converted to cents per thousand cubic feet for purposes of consistency with the remainder of this brief, and consequent greater clarity.

[Cents per Mcf]

	1960	1961	1962
January	14.98	16.01	16.40
February	14.98	16.20	16.72
March	15.16	16.12	16.60
April	15.15	16.15	16.55
May	15.18	16.21	16.74
June	15.29	16.28	16.61
July	15.62	16.30	16.65
August	15.97	16.46	16.36
September	16.05	16.50	
October	15.98	16.32	
November	15.87	16.31	
December	15.85	16.45	
Average	15.51	16.28	

The increases in the annual average price are as follows:

1954 over 1953	1955 over 1954	1956 over 1955	1957 over 1956	1958 over 1957	1959 over 1958	1960 over 1959	1961 over 1960
10.0%	7.1%	6.6%	6.2%	8.3%	10.0%	8.8%	5.0%

For the twelve months ended August 31, 1962, the increase over the preceding twelve months was 2.5%. The average price was 16.52¢ compared with 16.12¢ in the twelve months ended August 31, 1961.

APPENDIX C

1960 South Louisiana jurisdictional sales by 13 producers at prices above 21.25¢ (Mcf at 15.025 psia)

Producer	From Petitioner's Exhibit D-2 (No. 74, Br. page 42)		As adjusted to deduct non-jurisdictional sales and adjust for sales subject to refund		As adjusted to reflect 1962 settlements by Shell, Ohio, and Tidewater and to reflect settlements in certificate proceedings in Docket Nos. G-13169, G-13746 and related dockets	
	Total Mcf 1960	Estimated not subject to refund	Total Mcf 1960	Estimated not subject to refund	Total Mcf 1960	Estimated not subject to refund
Amerada	4,024,376	99,837	4,024,376	99,837	[3] 2,914,449	99,837
Cities Service	6,661,308	1,042,637	6,661,308	1,042,637	[4] 6,631,117	1,042,637
Continental	82,402,402	2,921,393	82,402,402	2,921,393	[5] 75,649,680	2,921,393
Gulf	27,100,259	5,646,958	27,100,259	5,646,958	27,100,259	5,646,958
Hunt Oil	8,892,149	26,199	8,892,149	26,199	8,892,149	26,199
Ohio	7,071,256	0	7,071,256	0	[6] 0	0
Phillips	42,697,022	23,950,166	42,697,022	[7] 4,723,411	[8] 37,201,986	[7] 4,723,411
Shell	132,882,136	14,009,648	132,882,136	14,009,648	4,753,099	0
Sohio	11,926,080	978,865	11,926,080	978,865	11,926,080	978,865
Sun	34,002,685	18,549,843	[1] 30,323,860	[1] [2] 240,547	30,323,860	240,547
Texaco	50,591,625	47,766,413	[1] 23,793,187	[1] [9] 5,108,791	23,793,187	5,108,791
Tidewater	14,011,377	11,382,513	[1] 11,887,217	[1] [9] 5,809,213	[9] 5,173,711	[9] 5,173,711
Union Producing	13,806,581	8,006,985	[1] 9,433,129	[1] 3,633,533	9,433,129	3,633,533
Total 13 producers	436,069,256	134,381,457	399,094,381	44,241,032	243,792,706	29,595,882
Total all producers	[10] 1,128,327,240		1,057,063,532		936,050,600	

[1] Sales of 36,974,875 Mcf to Humble Gas Transmission Co., (formerly Olin Gas Transmission Corp.) have been excluded because they are intrastate. Most of these (31,851,952 Mcf) are so shown at pages 102-3 of the Form 2 report relied on by petitioner. The remaining sales have been so identified by a letter from Humble in answer to our inquiry made to ascertain the facts. The sales are by the following producers in the amounts shown:

	Volume (Mcf)
Sun	3,678,825
Texaco	26,798,438
Tidewater	2,124,160
Union Producing	4,373,452
Total	36,974,875

[9] Sun's FPC Gas Rate Schedule No. 114 covers a sale of gas to United Gas Pipe Line Company as to which the Commission's issuance of a permanent certificate in Docket No. G-15122 was set aside and remanded in *United Gas Improvement Company* v. *F.P.C.*, 290 F. 2d 147 (C.A. 5), certiorari denied, 366 U.S. 596. On the remand, United Gas Improvement Company, which is one of the

Eastern Seaboard Companies, petitioners in No. 74 in this Court, has argued that the Commission has authority to require refunds (UGI brief, August 13, 1962, Docket Nos. G-13183, et al.) The Commission, in an order dated June 14, 1962, errata notice dated June 28, 1962, in *H. L. Hunt*, et al., Docket Nos. R162-467, et al., agreed. It described Sun's Rate Schedule No. 114 as being in effect subject to refund. Sun has actually made a settlement proposal involving a substantial refund. We therefore have eliminated volumes under Rate Schedule No. 114 from the "Not Subject to Refund" Column. Volumes sold under Rate Schedule No. 114 in 1960 were 14,630,471 Mcf.

[3] The Form 2 report of United Fuel Gas Co., relied on by petitioner, fails to list FPC rate schedule numbers applicable to certain of its purchases from the Erath field, South Louisiana. Petitioner therefore assumed that these purchases are not subject to refund. We have ascertained the numbers by letter from United Fuel Gas Co. Phillips Schedule No. 273 and Texaco No. 6 are both subject to refund. Tidewater No. 26 was the subject of a settlement which reduced the price below 21.25¢ as to approximately 40% of the gas sold under this schedule. *Tidwater Oil Co.*, Docket No. 13310, et al., order issued June 15, 1962. We have therefore adjusted petitioner's table with respect to these Erath Field sales as follows:

Producer	R.S. No.	Volume, Mcf	Not subject to refund
Phillips	273	16,707,861	.....
Texaco	6	15,858,184	.....
Tidewater	26	8,622,851	5,173,711
	.....	41,189,896	5,173,711

[4] Southern Natural Gas Co., Phillips Petroleum Co., Joint Venture Rate Schedule No. 1 covers a sale of gas to Transcontinental Gas Pipe Line Co. The related certificate application, Docket No. G-17444, was consolidated with the Texaco-Seaboard certificate proceedings, Docket G-13169, order dated January 10, 1962. That order provided for refunds "to the extent, if any, that the rate which has been collected exceeds the rate ultimately found to accord with the requirements of the public convenience and necessity." Order dated August 24, 1962, in Docket No. G-17444, provided for the calculation of the amount of refund, with interest. The amount of the settlement is to be paid not in cash, but in gas to be made available without further payment over the life of the contract. We have therefore excluded this sale from the "Not Subject to Refund" column.

[5] The Transco-Seaboard settlement reduced the price under certain rate schedules to less than 21.25¢, and the quantities so affected have therefore been excluded. The rate schedule numbers are listed in *Texaco Inc.*, Docket No. G-13169, *et al.*, order dated July 30, 1962 and *Socony-Mobil Oil Co.*, Docket No. G-13746, *et al.*, order dated August 24, 1962. The volumes under each rate schedule are taken from the purchasers' Form 2 reports, and are as follows:

Producer	*Mcf*
Amerada	1,109,927
Cities Service	30,191
Continental	6,752,722
Ohio	1,238,752
Phillips	5,495,036
Tidewater	1,916,319
Total	16,542,947

[6] The "Total All Producers" figure has been adjusted to reflect the adjustments made in sales by the thirteen producers listed in Exhibit D-2. We have not determined what adjustments should be made in this total with respect to sales of other producers.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1962

No. 72.

STATE OF WISCONSIN and PUBLIC SERVICE COMMISSION OF WISCONSIN, and PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK,

Petitioners,

v.

FEDERAL POWER COMMISSION and PHILLIPS PETROLEUM COMPANY,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

REPLY BRIEF FOR STATE OF WISCONSIN and PUBLIC SERVICE COMMISSION OF WISCONSIN, and PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK.

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Dated: December 14, 1962.

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REPLY BRIEF FOR STATE OF WISCONSIN and PUBLIC SERVICE COMMISSION OF WISCONSIN, and PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK.

In our main brief we contended that, having conducted its rate investigation of Phillips Petroleum Company to the point of decision, the Federal Power Commission was required to fix just and reasonable rates for Phillips by reference to the company's costs; and that it was not free to terminate the completed investigation without making a finding on the justness and reasonableness of Phillips' rates merely because it had, contemporaneously with its termina-

tion of the Phillips investigation, decided to explore a new and untried industry-wide method of producer regulation. We pointed out that the effect of the Commission's decision was to frustrate the primary purpose of the Natural Gas Act to assure that consumers would pay no more than a just and reasonable rate.

In its brief, the Commission presents a three-part defense of the action here under review. First, it states that the Natural Gas Act does not require any particular method of rate-making, so that it was free to reject the individual-company cost method proposed and pursued by all parties to the Phillips proceeding. Second, though it tacitly concedes that area rate-making cannot become effective for many years, it claims that the interim program it is following is "vigorous and effective" and has "arrested" the upward trend in producer prices. Finally, it contends that a remand here, requiring continued use of the individual-company cost method until such time as area pricing becomes effective, would interfere with and materially delay the conclusion of the area rate proceedings.

In this reply, we shall discuss each of the defenses raised by the Commission. In addition, we shall discuss the significance here of the Commission's *Hunt* opinion, decided subsequent to the filing of our main brief, and the contention, made principally by Phillips but echoed to some extent by the Commission, that certain of the issues which we raised in our main brief are not properly before this Court.

I. While the Natural Gas Act gives the Commission discretion to choose and effectuate any reasonable method of regulation, it does not give the Commission discretion to pursue a program which amounts to no regulation at all.

In what is apparently intended as a response to our contention that it may not abandon meaningful regulation, the FPC argues at length (FPC brief, pp. 17-35) that the Natural Gas Act endows the Commission with considerable discretion in the choice of a regulatory method. The Commission's purpose in presenting this argument is somewhat ambiguous. If, on the one hand, the Commission means to suggest that it should be given freedom to adopt and effectuate a new regulatory method at the conclusion of the area proceedings five or ten years from now, then its argument is surely premature—we have as yet seen nothing more than the preliminary and tentative outlines of such a new method, whose ultimate legality and desirability we do not and cannot now challenge.

If, on the other hand, this portion of the Commission's brief is intended as a defense of its *present* program for producer rate control—in which the element of cost is largely disregarded—then it constitutes a collateral attack on *City of Detroit* v. *F. P. C.*, 230 F. 2d 810 (D. C. Cir. 1955), *cert. denied*, 352 U. S. 829, and becomes an argument that the Natural Gas Act permits the Commission to fix rates for natural gas companies without regard to cost.[1] This

[1] In our main brief (pp. 20-21) we stated that it was not clear "whether the FPC's new area price method was intended merely to change the *unit* of regulation—from the individual producing company to all producers in a given producing area—or whether it was intended to change the *basis* of

argument finds no support either in the statute, in logic, or in the decided cases.

The specific provisions of the Natural Gas Act (Sections 5(b), 6, 8(a), 9(a), 10(a), and 14(b)) make clear that the Act was designed for cost-of-service regulation. See *Colorado Interstate Gas Co.* v. *F. P. C.*, 324 U. S. 581 at 602 (1945). But even if the statute were completely silent on the matter, it would be little more than elementary common sense that a regulatory agency, in fixing rates for a commodity or service, should ascertain what the seller's costs are in providing that commodity or service. Indeed, this principle is both so rudimentary and so deeply ingrained in regulatory statutes which, like the Natural Gas Act, provide for the fixing of "just and reasonable rates", that discussion of which method of regulation is to be followed implicitly means which method of *cost* regulation is to be followed, and it is extremely doubtful whether any method which ignores cost is in fact a method of *regulation*.

The Commission cites an impressive group of cases in support of its thesis that it has discretion to fix rates by any method it chooses, including a *non*-cost method. An examination of these cases, however, reveals that none contradict—in fact, most affirmatively support—petitioners' contention that under the Natural Gas Act rates must be based on cost.

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regulation—from fixing rates by reference to the cost of the regulated unit to fixing rates by reference to non-cost data."

We added that, on the basis of the representations contained in the FPC's Brief in Opposition to the grant of certiorari, we assumed that it was the intent of the FPC, "under its new method, to regulate on a cost basis".

To the extent that the Commission now attacks *City of Detroit*, however, it would appear that such an assumption was unwarranted.

The cases cited by the FPC fall into three groups: (1) six cases,[2] decided between 1944 and 1951, all affirming the FPC's use, in fixing rates, of a cost-of-service method incorporating an original-cost rate base; (2) three cases,[3] decided in 1958 and 1959, affirming FPC rulings that, as a matter of law, the Commission could not grant rate increases in the absence of cost data; and (3) two cases[4]—one decided in 1955, the other in 1961—reversing the FPC's allowance of rate increases in the absence of cost data.

It is thus clear that the *holdings* in these cases do not support the Commission's thesis that it is free to use a non-cost method. In recognition of this, the Commission relies not on the holdings but rather on selected passages (in many cases pure dicta) to the effect that the Commission is not bound to any particular formula in fixing rates. Even these, however, fail to support the Commission's thesis.

To begin with, it is plain from the context in which the passages appear that the courts were discussing no more than the issue before them—whether the Commission could use a cost method allowing return on an original-cost rate base rather than a cost method allowing return on a fair-value rate base. Thus, the statements that the Commission was not bound to any particular formula meant only that

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[2] *F. P. C.* v. *Hope Natural Gas Co.*, 320 U. S. 591 (1944); *Colorado Interstate Gas Co.* v. *F. P. C.*, 324 U. S. 581 (1945); *Panhandle Eastern Pipe Line Co.* v. *F. P. C.*, 143 F. 2d 488 (8th Cir. 1944), *affirmed*, 324 U. S. 635; *Cities Service Gas Co.* v. *F. P. C.*, 155 F. 2d 694 (10th Cir. 1946), *cert. denied*, 329 U. S. 773; *Interstate Natural Gas Co.* v. *F. P. C.*, 156 F. 2d 949 (5th Cir. 1946), *affirmed*, 331 U. S. 682; *Pennsylvania Water & Power Co.* v. *F. P. C.*, 193 F. 2d 230 (D. C. Cir. 1951), *affirmed*, 343 U. S. 414.

[3] *Bel Oil Corp.* v. *F. P. C.*, 255 F. 2d 548 (5th Cir. 1958), *cert. denied*, 358 U. S. 804; *Forest Oil Corp.* v. *F. P. C.*, 263 F. 2d 622 (5th Cir. 1959); *Episcopal Theological Seminary* v. *F. P. C.*, 269 F. 2d 228 (D. C. Cir. 1959), *cert. denied*, 361 U. S. 895.

[4] *City of Detroit* v. *F. P. C.*, 230 F. 2d 810 (D. C. Cir. 1955), *cert. denied*, 352 U. S. 829; *Minneapolis Gas Co.* v. *F. P. C.*, 294 F. 2d 212 (D. C. Cir. 1961).

the Commission had discretion to follow one cost formula rather than another, and not, as the Commission seems to argue here, that it has unlimited discretion to choose a non-cost method. Moreover, the repeated judicial observation in the opinions cited by the FPC that the Commission is permitted considerable latitude in giving effect to the Congressional purpose not only defines the breadth of the agency's discretion but the limitation on it as well. That is, discretion is implied as far as, but no further than, necessary to carry out the purposes of the Act.[5]

The Commission's mistaken reliance on the cited cases to support its thesis that cost is unnecessary may be explained in part by its confused use of terms: the Commission has repeatedly used "original-cost method" to mean the same thing as "cost method".[6] "Original-cost" refers to the manner in which rate base or investment is computed; the alternative to an original-cost rate base is a reproduction-cost or fair-value rate base.[7] But once the investment has been computed, by whatever method, it is then used as the base for allowing a return, which return

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[5] "In delineating the scope of review, the courts have left no doubt of their disposition to give the Commission a free rein in the effectuation of the Congressional purpose" [previously defined to be] "to 'protect consumers against exploitation at the hands of natural gas companies.'" *Cities Service Gas Co.* v. *F. P. C.*, *supra* note 4, at 698.

[6] A particularly flagrant example of the FPC's incorrect and imprecise use of these terms occurs at pages 19-20 of its brief, where the Commission alleges that it argued in its brief to this Court in the *Hope* case that, "although the cost-of-service method had not been expressly written into the statute, Congress intended cost of service to be used insofar as constitutionally possible." Reference to the FPC's brief in that case, however, reveals that the Commission did not argue this point at all; rather it argued that an original-cost rate-base method had been intended by Congress. Accordingly, the Commission's present contention that "the *Hope* decision rejected the substance of the very contention now advanced by petitioners" is without foundation in fact.

[7] There are, of course, variants of each of these methods.

is added to the allowance for actual operating costs to arrive at a total cost of service. It is the use of a cost of service to fix rates which constitutes the cost method.

Thus, a court holding that an original-cost rate base need not be used in fixing rates would *not* be a holding that a cost method need not be used.

The lack of precision which characterizes the Commission's use of terms also characterizes its use of quoted material. For example, on page 20 of its brief the Commission represents that in *Colorado Interstate Gas Co.* v. *F. P. C., supra*, this Court

> "suggested that the Commission would not be precluded from using an area-price approach ('Some have thought that to be the wiser course.' *Id.* at 601) in lieu of the rate-base method."

Wholly aside from the fact that such a suggestion would have no logical meaning—area pricing refers to the *unit* of regulation and could be applied on either a cost or non-cost basis, whereas rate-base method is a means for determining one element of an overall cost of service—the fact is that the Court simply did not make the suggestion which the Commission ascribes to it. We quote the passage from which the Commission has taken but a single sentence; in context, it means not what the Commission says but precisely the opposite:

> "It is obvious that when rates of a utility are fixed the value of its property is affected. For as we stated in the *Hope Natural Gas Co.* case, value is 'the end product of the process of rate-making not the starting point.' 320 U. S. p. 601. When a natural-gas company which owns producing properties or a gathering system is restricted in its earnings by a rate order, the value of all of its property is affected. *Congress of course might have provided*

> *that producing or gathering facilities be excluded from the rate base and that an allowance be made in operating expenses for the fair field price of the gas as a commodity. Some have thought that to be the wiser course. But we search the Act in vain for any such mandate.*" 324 U. S. at 601. (Emphasis added.)

Finally, the Commission relies on the cited cases to refute a position which it incorrectly ascribes to all petitioners—the position that under the Natural Gas Act the only method the Commission may use is an original-cost rate-base method. Such has never been our view. We freely concede that the Commission may use any reasonable cost method. What the Commission seems to advocate here is that it was free to reject the original-cost rate-base method, not because it was a *rate-base* method, nor because it was an *original-cost* rate-base method, but solely because it was a *cost* method. Thus, the issue on this aspect of the case is whether the Commission may fix rates without reference to *cost*, and not, as the Commission's brief suggests, whether in fixing rates it is limited to the original-cost rate-base method. If the Commission had actually fixed Phillips' rates by reference to a novel and unorthodox cost method, we would have an entirely different case, and it is this different case which the Commission appears to have briefed.

Perhaps the best and most comprehensive answer to the suggestion that the Commission has discretion to abandon cost was given by the Commission itself, six years ago, in the first producer case to raise the issue:

> "The applicants claim that the act does not limit the Commission to the use of any particular formula or combination of formulae in determining a just and reasonable rate under section 4(e). From that

premise applicants infer that the Commission may adopt the methods used to determine an unregulated price as a regulatory formula in rate making. . . .

"This reasoning is faulty. It supposes that because court decisions have held the Commission is not limited to the use of any one formula or combination of formulae in determining just and reasonable rates that the Commission is completely unfettered in its choice of ratemaking method. Applicants argue that in the exercise of its freedom of choice, the Commission should adopt the unregulated market as the proper guide in determining just and reasonable regulated rates. On this record it is not possible to strike a fair balance between investor and consumer interests. We cannot be sure that the rates are sufficient to promote exploration for and development of gas supplies and, at the same time, to provide the protection to the ultimate consumer contemplated by the act. Indeed, a delegation of power to make rates interpreted as broadly as applicants would have it, would permit the unregulated market to determine rates in the name of regulation. Such a result would be contrary to the clear direction of the act that this Commission should regulate these rates. *Phillips Petroleum Co.* v. *Wisconsin*, 347 U. S. 672 (1954).

"Sections 4 and 5 of the act set forth the end result test that rates charged by natural-gas companies shall be 'just and reasonable.' This is both a statutory and a constitutional requirement. *Federal Power Commission* v. *Natural Gas Pipeline Co. of America*, 315 U. S. 575, 586 (1942). We think the recent decision of the Court of Appeals for the District of Columbia Circuit in *City of Detroit* v. *Federal Power Commission*, 230 F. 2d 810 (C. A. D. C., 1956), *certiorari denied*, 352 U. S. 829, is controlling here. In referring the case back to the Commission for the taking of additional evidence, the Court held that in ratemaking the Commission must always 'relate its action to the primary aim of the act to guard the

consumer against excessive rates. If the Commission contemplates increasing rates for the purpose of encouraging exploration and development, * * * it must see to it that the increase is in fact needed, and is no more than is needed, for the purpose. Further than this we think the Commission cannot go without additional authority from Congress." *Id.* at 817.

"We think it is plain from the language of the *City of Detroit* case, *supra*, that the value method used alone, as proposed by the applicants, is not a method of ratemaking open to us within our delegated power." *Union Oil Co. of California*, 16 FPC 100 at 109-110 (1956).[8]

II. The Commission's present program is ineffectual.

A. Inadequacies of producer program are underscored by comparison with pipeline regulation.

In considering the efficacy of the Commission's present program for producers, it is instructive to compare that program with the Commission's regulatory procedures for pipelines. It should be noted, of course, that the Natural Gas Act does not distinguish between pipelines and producers; rather it provides for regulation of all natural gas companies, which are defined as companies making sales of natural gas in interstate commerce. In its 1954 decision in this case, the Court held that one who sells natural gas for resale in interstate commerce does not escape federal regulation merely because he happens to be a producer.

A comparison of the two programs—pipeline and producer—reveals clearly that the Commission has taken a tiptoe approach to producer regulation, attempting to inter-

[8] Affirmed, *Bel Oil Corp.* v. *F. P. C.*, 255 F. 2d 548 (5th Cir. 1958), *cert. denied*, 358 U. S. 804.

fere with pre-existing practices as little as possible: whatever its theoretical merits, this approach has, as a practical matter, led directly to the very administrative problems of which the Commission now complains (brief, p. 29).

1. *Uniform System of Accounts.* As an indispensable first step to effective regulation, it is clear that regulated companies must maintain their books of accounts on a uniform basis. One of the Commission's earliest actions, upon receiving jurisdiction under the Natural Gas Act in 1938, was to establish a Uniform System of Accounts for natural gas companies, 18 CFR, Chapter 1, Part 201. Upon being directed by this Court in 1954 to regulate producers, however, the Commission chose to exempt them from the requirements of the Uniform System, and even now, more than eight years later, it has yet to prescribe such a system for producers. As a result, any rate proceeding, whether it is on an individual-company basis or on an area-rate basis, must first be preceded by an exhaustive examination and recasting of the books of the regulated entity.

2. *Annual Reports.* The annual reports filed by pipelines (Form No. 2) are exceedingly comprehensive, thereby enabling the Commission to review promptly whether any pipeline is earning an excessive return. Regulations under the Natural Gas Act, §260.1. In contrast, the annual report required of producers (Form No. 301) is an abbreviated report which merely shows sales made under each rate schedule. Regulations under the Natural Gas Act, §§260.5 and 260.6. Indeed, even as to this information the Commission apparently takes the view that it can obtain more reliable figures from the pipeline's annual report (each producer's sale, of course, is a pipeline's purchase, which the pipeline is required to show in its Form 2). Thus, the Federal Power Commission issues each year a

report showing sales by producers to interstate natural gas companies derived wholly from the pipelines' Form 2's.[9]

3. *Rate Schedules.* Although the Commission, as a matter of expediency at the advent of regulation in 1938, permitted each pipeline to file its various sales contracts as rate schedules, it has since 1948 required each pipeline to file a uniform tariff, so that all of a pipeline's customers similarly situated may purchase gas under the same tariff provisions. Regulations, §154.1 *et seq.* At the same time, however, the Commission has permitted producers to file their sales contracts as separate rate schedules and has never required the filing of a uniform tariff.[10] Regulations, §154.91 *et seq.* Thus Phillips has over 300 contracts and over 300 rate schedules; based on a reasonable estimate that each rate schedule on the average permits Phillips to file for an increase once every three years (and many contracts call for annual increases), this means that Phillips would file 100 rate increases each year. Operating under the filed-tariff system, on the other hand, pipelines have in recent years averaged about one system-wide increase every two years. It is this multiplicity of producer filings which enables the Commission to engage in such fantasies as the projected inability to reach current status "until 2043 A. D." (FPC brief, p. 29). In point of fact, if the Commission were to require no more than that each of the *major* producers file a single comprehensive non-discriminatory tariff, the tariffs of the

[9] In its brief (pp. 42-43) the Commission is critical of the information compiled by the Eastern Seaboard companies from the Form 2's, and in an appendix (pp. 69, 70) makes adjustments to the Eastern Seaboard figures based on information obtained through a recent exchange of correspondence between the Commission and the regulated companies. The FPC's impeachment of information contained in its own files is, to say the least, surprising.

[10] Cf. the examiner's decision in this case, R. 210, 214-216, which, in effect, would have required Phillips to convert to the filed-tariff system.

25 largest producers would cover over 60% of all sales in interstate commerce.

4. *Data in Support of Rate Increase Filings.* Even though most pipelines have no contractual inhibition limiting their right to file increases, the fact is, as noted above, that they file only on the average of once every two years. The principal reason for this restraint is the Commission's regulation requiring that every Section 4 rate increase filed by a pipeline be accompanied by detailed material showing, *inter alia*, the cost justification for the increase requested. Regulations under the Natural Gas Act, §154.63. Filings which do not comply with the Commission's rules may be rejected. In contrast, a producer is permitted to accompany his Section 4 rate increase filing with little more than a summary description of the nature of the increase and a statement that the increase is not contractually prohibited. Regulations under the Natural Gas Act, §154.94. As a result, the practice has been for producers to file for every increase to which they are contractually entitled, whether or not such increase can be supported by a cost showing.

B. The Commission's application of its SGP rates affords no protection to the consumer.

The Commission asserts (brief, pp. 35-37) that its application of the rate levels announced in its Statement of General Policy constitutes an adequate regulatory program.[11] This assertion cannot withstand close scrutiny.

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[11] Cf. the recent dissenting opinion of Commissioner Morgan to the FPC's Fifth Amendment of its Policy Statement, August 30, 1962:

> "Under the terms of our Statement of General Policy No. 61-1, we have been attempting to carry out our responsibilities through the device of so-called *area prices—a currently fashionable synonym for what used to be called 'fair field prices.'*" (Emphasis added.)

The Policy Statement establishes in each area two levels of rates, the "old gas" rate and the "new gas" rate. The "old gas" rate, derived from the weighted average price in 1959, is used by the Commission to determine whether to suspend and investigate rate increases filed pursuant to Section 4. If, for example, a producer files for an increase from 10¢ to 15¢ in an area where the "old gas" price is 15.75¢, the Commission will not suspend or investigate even though the increase may amount to several million dollars annually and even though the increase will be passed along by the pipeline to its distributing company customers and by them to the ultimate consumer. If, on the other hand, a producer in the same area files for an increase from 15¢ to 16¢, the increase will be suspended.

(It is quite true that Section 4(e) speaks in permissive language with respect to the Commission's suspension of rate changes. As a matter of practice, however, the Commission has almost invariably suspended all *pipeline* rate increases filed under Section 4 and has set the justness and reasonableness of such increases for hearing even though, as noted, the pipeline is required to submit very substantial cost data in justification of the rate increase.[12] It was not until the advent of producer regulation that the Commission began on a wholesale basis to exercise its discretion *not* to suspend. To the extent this discretion is exercised, it always works to the benefit of the producer, who is thus freed from the obligation of proving his rate just and reasonable; the value of this benefit is enhanced by the fact

[12] The only instances we know of where pipeline rate changes are not suspended are (a) where the proposed change is a change in the form of the rate rather than a rate increase and (b) where the rate change is made pursuant to Commission direction following a hearing and decision in an earlier proceeding—as, for example, where the Commission in a given proceeding finds that a certain type of service is not bearing its fair share of overall costs.

that the producer need not present cost justification as part of his filing.)

The average price used by the Commission as a standard for determining whether to suspend is, of course, made up of prices which are both above average and below average. By adopting a policy which permits the below-average price to rise to the average level, the Commission permits an increase in the average itself. And unless it is assumed that a price is just and reasonable because it is no more than the average—an assumption inconsistent with *City of Detroit, supra*—then the Commission's policy permits, without suspension, investigation, or purported justification, increases to levels which are not just and reasonable.

The "new gas" prices stand on little better footing. These levels, based on the highest previously certificated price in each area, are used to determine whether a new price is "out of line" within the meaning of this Court's Catco decision, *Atlantic Refining Co.* v. *Public Service Commission of New York*, 360 U. S. 378 (1959). To the extent that such levels are above the in-line level—and many, having been based on subsequently condemned initial prices, are—they have no validity whatsoever. To the extent that they coincide with the in-line level, they neither add to nor detract from the level of protection required by *Catco*. The Commission's claim that changes in its Policy Statement prices reflect an active regulatory program is at best a gross overstatement—the two occasions which the Commission cites are merely cases in which the Commission has attempted to correct, and then not successfully, earlier errors which it had made when it announced price levels that were out of line under the relevant court decisions. Thus the original 23.25¢ Southern Louisiana initial price level announced by the Commission in October 1960 (24 FPC 902; 24 FPC 1020 at 1038) was based on price

levels involved in the reversals by this Court of *Catco* (*Atlantic Refining Co.* v. *Public Service Commission of New York, supra*) and *Transco-Seaboard* (*Public Service Commission of New York* v. *F. P. C.*, 361 U. S. 195 (1959)).[13] In belated recognition of these reversals, the Commission in October 1961 reduced the Southern Louisiana price by 2¢—to 21.25¢ per Mcf on-shore and 19.5¢ per Mcf off-shore, 26 FPC 661. (In light of the Commission's subsequent determination in the remanded *Catco* case, 27 FPC 96, that the appropriate in-line price is 20¢ on-shore and 18.5¢ off-shore, the present level still appears to be excessive.)

The second reduction referred to by the Commission—from 18¢ to 16¢ in Texas District No. 4—has a similar history. The 18¢ level had also been based on price certifica-

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[13] The Commission's statement (brief, p. 36) that the originally announced Southern Louisiana level was "21.5¢ *plus* State taxes of 2.3¢ per Mcf" is factually incorrect, as is the subsequent statement that the "reduction for State-taxed gas was 2.55¢ per Mcf". Actually, the originally announced ceiling was 21.5¢ plus *reimbursement* for State tax; since the usual reimbursement provision in producer-pipeline contracts called for reimbursement of only a portion of the State tax, which the Commission subsequently found to be 1.75¢ per Mcf, this meant that the level was 23.25¢—not 23.8¢ as the Commission now suggests in its brief. Similarly, when the Commission in October 1961 reduced this level to 21.25¢, the reduction was a 2¢—not a 2.55¢—reduction. The Commission's error in this regard is surprising inasmuch as the Commission's own press release issued at the time the level was reduced specifically refers to the original price level as 23.25¢ and to the reduction as a 2¢ reduction. See FPC Release No. 11705, October 31, 1961:

> "Washington, D. C., October 31, 1961—The Federal Power Commission today announced reductions of 2 cents per thousand cubic feet in the ceiling price levels on new sales of natural gas by independent producers from Southern Louisiana and Louisiana territorial waters.
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> "The previous maximum price for both on and off-shore sales was 21.5 cents per thousand cubic feet, exclusive of state taxes. Tax reimbursement provisions vary from contract to contract. Generally, however, the FPC has utilized a total ceiling price of 23.25 cents, including taxes. Today's action accordingly results in a 2-cent reduction in the previously-used total ceiling price."

tions subsequently reversed by the courts. In a recently concluded evidentiary proceeding, *Skelly Oil Co.*, G-18638, order issued August 30, 1962, the Commission determined that at the time of the Policy Statement the appropriate price line was 15¢. Instead of reducing the erroneous 18¢ level to correspond to its own evidentiary finding, however, the Commission reduced it only two-thirds of the way; two commissioners dissented, contending that the price level should be reduced to 15¢.

In any event, the "new gas" levels are substantially in excess of the average price, so that Commission certification of new sales at these levels is certain to cause a rise in the average itself. In this respect, use of the "new gas" ceilings has the same inflationary effect as use of the "old gas" ceilings.

C. The Commission's claim that price increases have been "arrested" is questionable and, in any event, is irrelevant.

Central to the FPC's defense is its representation that it has "arrested" the rise in natural gas prices; in support of this claim, the Commission presents two graphs (FPC brief, pp. 34, 35).

Although the Commission appears to be using "arrest" in the sense of "stop" or "halt", the figures and graphs presented by the Commission show not that the price increases have been halted but only that the rate of increase is not as steep as previously.[14] This may be good differen-

[14] The Commission states (brief, pp. 34-35) that in 1961 the weighted average price of gas increased by only 5% over 1960, and that in 1962 the percentage might even be less. In developing this thesis the Commission relies on Bureau of Labor Statistics figures, which may be somewhat understated in that they do not include producer sales made to Tennessee Gas Transmission Company, in recent years a large and consistently high-cost purchaser. Although the Commission also represents (brief, p. 35, n. 19a) that

tia. alculus, but it does not qualify as good regulation: price stability at levels never tested for justness and reasonableness manifestly deprives the consumer of his basic statutory right to pay no more than "the lowest reasonable rate", especially where, as here, the level is an all-time high, more than double the level of the early fifties and more than triple the level of the mid-forties. (See Appendix A.)

Since the FPC relies so heavily on the BLS figures, some price comparisons are in order. The BLS natural gas series is part of the wholesale price index; it was instituted in January 1958, at which time the average wellhead price was 12.38¢ per Mcf, and it is computed on the basis of January 1958 equals 100. The most recent BLS figures (September 1962 preliminary) show a natural gas index of 135.1. For all wholesale prices, using a base of 1957-59 equals 100, the September 1962 index is 101.2; for all commodities other than farm and food, the index is 100.8; and for "fuels and related products, and power", the group heading under which natural gas is included, the index again is 100.8. The BLS data thus reveal that while the past five years have been a period of almost complete stability in wholesale prices generally, one wholesale price, and a regulated one at that, natural gas, has risen dramatically. Nor would a materially different result be obtained by using a different base period; in each year since 1950, the average wellhead price of gas has set a new record high.[15]

"preliminary indications are that October [1962] will show a decline", we are advised by BLS, as this brief goes to press, that no October figures are as yet available.

[15] Comparative data shown in Appendix A.

D. Price stability achieved in certain cases is a result of intervener effort.

At pages 37-44 of its brief the Commission argues that "stable prices at lower levels have been achieved in numerous important cases." Most of the cases cited by the Commission are those in which the stability resulted from the efforts of interveners (including the petitioners here), frequently after obtaining court reversal of improper FPC action.

For example, the Commission alleges (brief, pp. 38-39) that in the remanded *Catco* case, following hearings, a lower initial price was fixed, and that similar results have been achieved through settlement in numerous other cases. The Commission does not state that *Catco* was remanded at the instance of the New York Commission and other interveners; that most of the cases in which the initial price was reduced through settlement were proceedings remanded by the courts at the instance of the New York Commission and the distributing company interveners; and that in each of the settlements it was the accord or acquiescence of the interveners that permitted disposition of the docket.

In the *Skelly Oil* proceeding, referred to at page 39 of the Commission's brief, the lower price was urged by the New York Commission and the three distributing company petitioners in No. 74.

The matter of the producer rate settlements (FPC brief, pp. 39-40) has already been covered in our main brief (pp. 33-36); we note here merely that the settlement prices approved by the FPC were based on field price standards and were substantially in excess of the rates that would have resulted from application of cost-of-service principles.

With respect to the Commission's action in Section 4(e) proceedings (FPC brief, pp. 40-41), it is quite true that the FPC has recently set a handful of extremely high prices for expedited hearing; but again, this procedure was first taken at the instance of a distributing company intervener.

The Commission's reference to the *Hunt Oil Company* case, Opinion No. 365, issued October 17, 1962, is discussed below (Point IV, *infra*).

III. The area price venture would not be delayed by a remand here.

The Commission alleges (brief, p. 47), "it is clear that the Commission cannot effectively pursue both [the area rate proceedings and the individual-company rate cases] at the same time" and (brief, p. 45), "It is clear, moreover, that a decision by this Court, the effect of which is to require the Commission to reopen the records in this and all other unsettled Section 5(a) cases in which hearings have been completed, would necessarily tend to delay area rate proceedings." The Commission nowhere furnishes the basis for its claim that remand would cause delay, and it is certainly not clear to these petitioners, who have participated extensively in FPC proceedings over the past eight years, that delay would result or even tend to result.[16]

The reason little, if any, delay may be anticipated can best be understood by comparing the widely different procedural statuses of the individual-company rate cases, on the

[16] Nor is such a claim clear to the Commission's examiners who have actually heard and decided major producer rate cases. See, e.g., *Gulf Oil Corp.*, G-9520 *et al.*, Examiner's Decision issued September 24, 1962, Mimeo. pp. 5-6, 77-79, reprinted as Appendix B hereto.

one hand, and the area rate proceedings, on the other. There is presently only one area rate proceeding in progress; there is little likelihood that the hearing will conclude within a year; and following the conclusion of the hearing, it can be anticipated that another twelve to eighteen months will be required for briefing and examiner's decision. Accordingly, there will be no area rate case for the Commission to decide for at least another two years.

On the other hand, a reopening, *where necessary*, of the individual company rate cases in which hearings have been concluded would require only a very brief period, on the order of 30 to 60 days. This is not a matter of speculation: following the Commission's *Phillips* decision under review here, the records in a number of pending producer cases were reopened to permit all parties to make cost presentations based on their interpretation of the cost-finding methods used by the Commission in the *Phillips* opinion; in almost all instances this phase of the proceedings took less than 90 days and did not require any additional field investigation by any party.

Thus, as a practical matter, the disposition now of the individual-company cases, which are 95% complete so far as the evidentiary phase is concerned and which require only Commission decision, will not interfere with the progress of the area rate proceedings, which in their present posture require additional staff work but no Commission decision for some years.

There are, moreover, sound reasons why the individual-company cases should be decided as promptly as possible. In the first place, the disposition of the individual-company cases will assure that at least the rates of *those* companies are just and reasonable; surely some progress is better than none at all. In the second place, the decision of the individ-

ual-company cases will necessarily dispose of many of the issues which otherwise would be deferred until decision of the area rate proceedings; this cannot help but expedite the area rate hearings.[17] Finally, despite the Commission's present favorable attitude toward area pricing, there is no guarantee that, faced with a specific record in the first area rate proceeding to come before it, the Commission will conclude that area pricing is a desirable or even a workable method.[18] To the extent that the Commission proceeds on a company-by-company basis, it will accomplish definite and tangible results which will, at the very least, provide a hedge in the event that area rate making should prove to be less than the panacea it is now thought to be.

Before leaving this point, we would like to make clear that we have never insisted in this case or in any of the pending proceedings that the record *must* be reopened to receive later test year data. It is our view that the Commission may properly fix rates based on test year costs

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[17] In this respect it is important to note that deferring the ultimate resolution of matters inherent in an individual-company case to an area rate proceeding does not avoid the problem; it merely delays its disposition. The Commission's allegation (brief, p. 29) that "the difficult choice between one or another method [of cost allocation] may, in the case of any given producer, mean the difference between bankruptcy and large profits" is hardly an argument in support of area rate making, for there the equally difficult choice could mean the difference between bankruptcy and large profits for all producers in an area.

[18] In point of fact, the industry-wide approach is not really new. In 1958, the Commission consolidated a substantial group of then-pending Section 5(a) proceedings—*Champlin Oil Co. et al.*, G-9277 *et al.*, popularly known as the Omnibus Case—and extensive hearings were held at which the major producers, various interveners, and the FPC staff presented, cross-examined, and rebutted industry-wide information. This hearing, which ran 41 days during which 5600 pages of transcript were compiled, concluded in March 1959; so far as we know, no use has ever been made of the evidence so expensively accumulated there.

that are several years old.[19] If the *Commission* feels that the test year data are too stale, however, we do not contest its right to reopen for receipt of more current information. In short, our position has been that the Commission may either fix rates on the basis of the test year data, or, if it chooses, reopen for later data. The one alternative which we insist is *not* open to the Commission is dismissal of the proceedings merely because of a belief that the test year data are too stale.[20]

IV. The Commission's decision here is at odds with its most recent opinion on producer rate matters.

We noted in our main brief that in the two years following its Phillips decision the FPC had not taken action on any other producer rate case, although four such cases had been decided by FPC examiners and were ready for Commission decision; we also noted that hearings had concluded with respect to eight other producers. Subsequent to the filing of our brief, examiners have rendered decisions in two more cases—*Gulf Oil Corp.*, G-9520, Examiner's Decision issued September 24, 1962, and *Sohio Petroleum Co.*, G-8488, Examiner's Decision issued October 30, 1962. But the most significant intervening development has been the Commission's Opinion issued October 17, 1962 in the *Hunt Oil Co.*

[19] Our contention that the Section 4 dockets were improperly terminated is not, as the Commission professes to believe (FPC brief, p. 49), "essentially an argument that the record was stale", but is rather an argument that the 1954 test year data insofar as they related to revenue deficiency failed to justify allowance of the increases for the years 1955-1959, when revenues increased sharply.

[20] The Commission's fear that fixing present rates on the basis of an old test year will be unfair to the producer is, we think, exaggerated. See the response of the examiner in this case (R. 194-195) that Phillips would, at all times, "have the opportunity to file a new rate proceeding for the purpose of determining a new cost of service and a new level of 'just and reasonable' rates based thereon."

rate case, G-9065 *et al.*, one of the four cases previously decided by a hearing examiner. (At the time of its decision, the *Hunt* proceeding had been before the Commission for about a year, the examiner's decision having been rendered on October 2, 1961.)

In the Opinion,[21] which runs only six pages, the Commission finds that the record does not support Hunt's request for an increase but that

> "since the record was made prior to *Phillips*, when few guideposts had been laid down, we will remand the case to the examiner in order to give Hunt further opportunity to shoulder its burden of proof by introducing evidence solely on the items discussed herein in which we find the record deficient. *Such evidence shall be restricted to data for the test year utilized in the present record.* Other parties to the proceeding may also submit evidence under the same limitations if they so desire." (Emphasis added.)

After setting forth the items on which it desires additional evidence, the Commission concludes with these three paragraphs:

> "In addition to obtaining additional evidence and ascertaining a proper cost-of-service for Hunt it will also be necessary for the examiner to receive evidence and make findings as to whether the individual increased rates here in issue are just and reasonable. Our examination of the record in this case convinces us that *increased rates for specific sales cannot always be found to be just and reasonable solely on the basis of a comparison of individual company-wide costs with that company's revenues in a test year.* The mere fact, if it turns out to be a fact, that

[21] We have been advised by petitioners in No. 74 that the *Hunt* Opinion will be set forth in full as Appendix B to their reply brief.

company-wide overall unit costs for the test period are greater than comparable unit revenues cannot justify all specific rate increases no matter how high they may be; the deficiency may well result from the fact that other sales are made at rates below that which could be justified on a cost basis. In any event consumers should not necessarily be obligated to make up overall revenue deficiencies by paying rates which are higher than those prevailing in the production area where this higher price cannot be individually justified.

"*The use of individual company costs as a method for determining whether an independent producer's increased rates are just and reasonable appears to be necessary if we are to pass upon such rates at all prior to the establishment of area rates.* Cost-of-service was the method which was used in this proceeding and others pending before the Commission prior to the commencement of the area rate proceedings and, as we have previously indicated, we intend to continue to process and decide such proceedings as promptly as the record in each case permits. We believe that the record in these proceedings, as supplemented on remand, should provide a basis for determination of the justness and reasonableness of Hunt's section 4 increased rates at the time they became effective.

"The Section 5(a) aspect of the proceedings is in a different posture. There are currently pending area rate proceedings in the Permian Basin and Southern Louisiana in which a large percentage of Hunt's jurisdictional sales are the subject of investigations pursuant to Section 5(a). It is our hope that area proceedings will result in a timely determination of Hunt's rates for the future. However, in order to assure adequate protection to consumers against any unreasonably high rates of Hunt which may not be subject to an early determination on an area basis we will hold in abeyance further action

> on the 5(a) aspects of the case pending area rate determinations, with the understanding that 5(a) proceedings on some or all of Hunt's rates may be subject to reactivation if future circumstances should so dictate." (Emphasis added.)

The holding in *Hunt*, which represents the views of a unanimous Commission, seems to us to constitute a confession of error on the Section 4 aspects of this appeal and, by implication at least, a partial confession of error on the Section 5 aspects. (It is true that the Commission treated Hunt's Section 5 docket in a different manner than it treated the Section 4 dockets, but the logic of its treatment of the Section 4's would seem to carry over to the Section 5.) In its brief, the FPC attempts to distinguish *Hunt* on two grounds. First, it states (brief, p. 41) that in *Hunt* only "relatively minor supplementation of the record is required." Precisely the same is true of *Phillips*. Second, the Commission states (brief, p. 53, n. 37) that the potential discrimination in *Hunt* can be taken care of in the Section 4 dockets, whereas here, since the Section 4 dockets cover only past periods, present discrimination could not be eliminated by disposition of those dockets. We submit that discriminatory rates collected in the past may be partially corrected now through ordering refunds of all amounts in excess of a non-discriminatory rate, and that present discrimination could be eliminated by entering an order in the Section 5 docket as well. Both of these remedies were, in fact, recommended by the examiner in this case.

V. The issues raised by petitioners are properly before this Court.

Phillips Petroleum Company argues strenuously (Phillips brief, pp. 19-23) that the issues presented by petitioners

are not properly before this Court; the point is partially concurred in by the Federal Power Commission (FPC brief, p. 52). In essence, respondents argue that we did not properly preserve the objections urged here in that we failed to raise the matters in our petitions for rehearing to the Commission; in addition Phillips alleges that we have raised in our main brief an issue not presented in our petition for certiorari.

It is our position that all issues presented in our main brief were raised either by Wisconsin's or New York's application for rehearing; that in any event these issues were raised by other parties, thereby giving the Commission an opportunity to pass on them prior to the taking of an appeal; and that the two questions presented in our main brief are merely a logical division of the one question presented in our petition for certiorari.

The application for rehearing filed by Wisconsin (R. 349-362), while it did not challenge the dismissal of the Section 5 investigation, clearly challenged both the FPC's disavowal of cost as a basis for regulation under Sections 4 and 5 of the Act (R. 352-353) and the FPC's allowance in the Section 4 dockets of specific increased rates which were in excess of the average cost of service determined by the Commission (R. 360-361). In its brief to this Court the Commission suggests that Wisconsin did not adequately raise the discrimination issue in seeking Commission rehearing; we note that, in denying rehearing, the Commission itself regarded Wisconsin's allegation as a claim of discrimination (R. 397):

> "The fact that some of [the increased] rates are in excess of the average cost of service determined by us is immaterial. Phillips' rates would normally vary greatly because the sales are made at widely separated points and under different conditions, *and*

there is nothing to show that these rates are discriminatory or preferential." (Emphasis added.)

New York's application for rehearing was mailed from New York in time to reach the Federal Power Commission within the 30-day period of Section 19(a), even as interpreted by the FPC, and copies of the petition did in fact reach all other Washington parties within that period. The FPC, however, asserted that its copies arrived a day late and for that reason rejected New York's application. Because the points raised in New York's application for rehearing (including specifically the Section 5 point) were, as the Commission itself noted,[22] covered by the applications filed by other parties, and because the other parties were in the process of preparing appeals, it seemed to New York that, rather than litigate whether its application had been timely filed, it would be more appropriate merely to seek intervention in one of the other appeals. That course was followed in the court below and, over the FPC's objection, New York was permitted to intervene in the Eastern Seaboard distributor company appeal (D. C. Cir. No. 16177) as a party-intervener in support of petitioners; accordingly, it stands in the same position as the parties on whose behalf it intervened. Even Phillips would concede that the Section 5 point was raised by the Eastern Seaboard distributors.

In any event, the federal courts have been loath to expand the rule, that an objection must be raised below

---

[22] In rejecting New York's application, the FPC stated (R. 399-400):

> "Actually the application was directed to some of the same problems covered by the other applications for rehearing, particularly our decision not to determine Phillips' rates for the future, so that if we had accepted PSC's application for rehearing we would not have reached a different conclusion."

before it will be considered on appeal, beyond the limits of the reason for the rule. The leading case in this area is *Hennesey* v. *S. E. C.*, 285 F. 2d 511 (3rd Cir. 1961). In that case, Hennesey had intervened in an SEC proceeding and had appeared at the opening day of hearings to voice its objections to the application there involved. Hennesey did not, however, participate in the lengthy hearings which followed; neither did it file a brief with the examiner nor exceptions with the Commission when the examiner decided in favor of the applicant. When Hennesey sought review of the Commission's grant of the application, the applicant before the SEC moved to dismiss, relying on Section 43(a) of the Investment Company Act of 1940, 15 U. S. C. §80a-42(a), which reads:

> "No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission or unless there were reasonable grounds for failure so to do."[23]

The points which Hennesey sought to raise on review had not been raised by it before the SEC, although they had been raised by other parties, none of whom took an appeal. The Third Circuit held that, for purposes of review, it is sufficient that the issues be raised before the agency. The purpose of Section 43(a), said the court, was to assure

> "that it is the agency and not the courts which passes first on the contentions of the participants. . . . This purpose is advanced so long as the contentions and exceptions raised on review have been in fact effectively and meaningfully raised before the regulatory agency. This is true regardless of whether the person who appeals the agency decision or some other person aggrieved by the decision happens to have

[23] This provision is virtually identical to the corresponding provision of Section 19(b) of the Natural Gas Act.

raised the points before the agency." 285 F. 2d at 515.

The court further noted that any other interpretation would be inconsistent with the maintenance of orderly and rational procedure before the agency. If each person were required to raise every contention and argument which he wished to preserve for appeal,

> "such a person would be forced to pursue one of two equally futile courses. Either he would have to repeat the testimony, cross-examination, exceptions, briefs and the other activities of the participants with interests, like to his, . . . or he could, at the conclusion of each step of the litigation formally adopt all that had been done by others . . . in a kind of 'me-too' manner." *Id.* at 516.

Under *Hennessey*, therefore, the question is whether the objections presented here by Wisconsin and New York were urged in *any* application for rehearing; the Commission's order denying rehearing demonstrates that the Commission, at least, was satisfied that they were.[24]

The argument made by Phillips (brief, p. 23) that the division of the single question in our petition for certiorari into two points in our main brief violates the rules of this Court is without merit. Contrary to Phillips' suggestion, the statement of the question presented in our petition specifically referred to both Sections 4 and 5 of the Natural Gas Act; in our brief on the merits we merely separated the Section 4 and Section 5 points for greater convenience in briefing.

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[24] To the extent that our arguments in this Court are phrased in somewhat different language than in our applications for rehearing before the Commission, it is due in large measure to the present posture of the case and the regulatory situation resulting from the court of appeals' decision.

Conclusion.

The consumer's basic right under the Natural Gas Act is to just and reasonable rates. As we have shown, these can be determined only by reference to costs. In this proceeding the Commission terminated the Section 4 dockets, even though many of the increased rates thereby allowed for the past period (1955-1959) exceeded Phillips' cost of service and hence were not just and reasonable, and it terminated the Section 5 investigation, even though most of Phillips' present rates and its average revenue exceed the cost of service. Moreover, the Commission's present program of producer regulation—of which its Phillips decision is a key part—permits the continued collection of rates which have never been tested as to their justness and reasonableness and which, under the Commission's program, will not be for years.

For the reasons set forth here and in our main brief, petitioners respectfully request that this Court vacate the judgment of the court of appeals and direct that court to remand the case to the Federal Power Commission for the

purpose of fixing just and reasonable rates for Phillips Petroleum Company on the basis of its costs.

Dated: December 14, 1962.

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APPENDIX A.

The Field Price of Natural Gas, 1938-1962.

In its brief, the Federal Power Commission relies on field price information published by the FPC since 1953 and by the Bureau of Labor Statistics since January 1961. We believe that it would be helpful for the Court to have field price data for the entire period since 1938.

There are three governmental sources which publish such data:

1. The Bureau of Mines (Department of the Interior) has published figures for each year since 1938; its figures cover all sales, both interstate and intrastate.

2. The FPC has published figures for each year since 1953; the FPC data cover interstate sales only.

3. The Bureau of Labor Statistics has published monthly figures since January 1958; these figures, which are collected for the Bureau by the American Gas Association, represent sales to about twenty major pipelines, all but one of which are interstate.

	Bureau of Mines (all figures in cents per Mcf)	FPC	BLS
1938	4.9¢	—	—
1939	4.9	—	—
1940	4.5	—	—
1941	4.9	—	—
1942	5.1	—	—
1943	5.2	—	—
1944	5.1	—	—
1945	4.9	—	—
1946	5.3	—	—
1947	6.0	—	—
1948	6.5	—	—
1949	6.3	—	—
1950	6.5	—	—
1951	7.3	—	—
1952	7.8	—	—
1953	9.2	9.0¢	—
1954	10.1	9.9	—
1955	10.4	10.6	—
1956	10.8	11.3	
1957	11.3	12.0	—
1958	11.9	13.0	12.9¢
1959	12.9	14.3	14.3
1960	14.0	15.6	15.5
1961	15.1	—	16.3

Monthly Data (per BLS).

	1958	1959	1960	1961	1962
January	12.38¢	14.05¢	14.98¢	16.01¢	16.40¢
February	12.62	13.93	14.98	16.20	16.72
March	12.56	14.11	15.16	16.11	16.60
April	12.74	14.05	15.15	16.15	16.55
May	12.77	14.26	15.18	16.21	16.74
June	12.63	14.10	15.29	16.28	16.61
July	12.70	13.95	15.62	16.30	16.65
August	13.03	14.49	15.97	16.46	16.36
September	13.03	14.38	16.05	16.50	16.72
October	13.37	14.45	15.98	16.32	—
November	13.32	14.55	15.87	16.31	—
December	13.60	14.82	15.85	16.45	—
Average	12.90¢	14.26¢	15.51¢	16.28¢	—

APPENDIX B.

UNITED STATES OF AMERICA

FEDERAL POWER COMMISSION

Decision.

Gulf Oil Corporation — Docket Nos. G-9520 *et al.*

UPON A CONSOLIDATED PROCEEDING UNDER SECTIONS 4(e) AND 5(a) OF THE NATURAL GAS ACT TO DETERMINE JUST AND REASONABLE RATES FOR AN INDEPENDENT PRODUCER.

(Issued September 24, 1962)

* * * * * *

HALL, Presiding Examiner:

* * * * * *

The minimum task of the Commission at this stage of producer rate regulation is to carry on on a case-by-case basis and do now what it is capable of doing. This will maintain consumer protection and bring meaningful knowledge in the consideration of area methods. As stated by the Examiner in his decision issued April 9, 1962, in *Amerada Petroleum Corporation, Docket Nos. G-9385, et al.* (p. 19 (mimeo)), "Individual cost-of-service rate making proceedings are still laboratories where many valuable lessons in rate regulation may be learned on a small scale without involving the whole industry in every experiment." The valuable lessons will flow directly from the fact that individual cases, through a more thorough churning of facts, claims and counterclaims, will enable the Commission to sort things out; make them clear; and keep them simple. Moreover, action in individual cases makes regulation a present reality rather than a distant hope, with each new case being approached with a background of progress and greater perspective.

The wisest approach to producer rate regulation is not to permit gaps in such regulation pending the testing of

different methods. In fact the frequently announced policy of the Commission—since the issuance of its decision on September 28, 1960, in *Phillips Petroleum Co.*, 24 FPC 537—to move forward with individually determined producer cases appears to reflect the fact that no area proceeding has been concluded and it would be unwise to prejudge the outcome of those proceedings. Time is important and could be irretrievable. Under no circumstances can the Commission take the chance of seeing each day that passes without producer regulation bring closer the day when all could appear to be hopeless.

• • • • • •

In conclusion the Examiner desires to point out that this case, like the *Amerada, Sun, Union* and several other independent producer rate cases have proceeded through pioneering and costly stages and required greater amounts of time in hearing initially than will hereafter be required because these types of cases had not been processed prior to *Phillips*. Initial decisions have been written by Examiners in a number of cases. In other proceedings the hearings have been concluded and initial decisions may be expected soon. Of special significance in this connection is the fact that the pending producer rate cases now ready for decision present, for the most part, common basic contested issues, which are extremely few in number (see note, 6, p. 8, *supra*), so that the decision in any one of the pending cases will necessarily decide the substantial issues in nearly all pending producer rate cases. In these cases it is not the basic facts which are in dispute, but only the principles which are to be applied to those facts. Accordingly, Commission decision on the fundamental issues in this or any other pending basic rate case is the most feasible method of reaching final decision in all such cases within a reasonable time. Moreover, such action may implement and aid in the expedition and conclusion of area proceedings (see pp. 5-6, 31, note 22, *supra*) by providing guidelines for the Examiners and the parties in those proceedings. On the other hand, should the Commission per-

mit all the pending independent producer cases now in advanced stages to be settled without fixing uniform rates for the future, the time, effort, expense, etc., which went into those proceedings to clear away uncertainty will largely be wasted and the full usefulness of those proceedings negated and the producer situation left confused and undecided.

* * * * * *

The Commission has within its grasp the power to perfect the general application of its decision in this case and its action will have a most salutary effect in development and articulation of guiding principles all along the line of producer regulation. Insofar as the *City of Detroit* and *Panhandle* cases are concerned, the one great principle making an indelible impression is that when the Commission departs from fundamentals of rate-making, which have not changed, its action is reversed, as it was in *City of Detroit*, and when it returns to and continues to apply those fundamentals its decision is sustained, as it was in *Panhandle*. In this connection it seems appropriate to observe that a Commission determination on the merits of this and the other combination Section 4(e) and 5(a) proceedings now pending, particularly because of their precedential value, will do more to break the logjam of pending rate cases, as well as many certificate cases, than any other action which the Commission can now take.

This case is a good case for regulatory action in the total public interest, if it is known what to do with it. The Commission having directed the Examiner to determine Gulf's rates on the basis of the record herein; to eliminate preference and discrimination among Gulf's customers; and fix Gulf's rates for the future, knows what to do with it. The Commission's obligation now is to carry on through with its original intention in setting this consolidated proceeding for hearing. [Mimeo. edition, pp. 5-6, 77-78, 79]

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1962

LONG ISLAND LIGHTING COMPANY, PHILADELPHIA ELECTRIC COMPANY, and THE UNITED GAS IMPROVEMENT COMPANY, *Petitioners*

v.

FEDERAL POWER COMMISSION, PHILLIPS PETROLEUM CO., *Respondents*

On Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

---

REPLY BRIEF OF LONG ISLAND LIGHTING COMPANY, PHILADELPHIA ELECTRIC COMPANY, AND THE UNITED GAS IMPROVEMENT COMPANY

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December, 1962

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IN THE

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No. 74

LONG ISLAND LIGHTING COMPANY, PHILADELPHIA ELECTRIC COMPANY, and THE UNITED GAS IMPROVEMENT COMPANY, *Petitioners*

v.

FEDERAL POWER COMMISSION, PHILLIPS PETROLEUM CO., *Respondents*

On Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

---

REPLY BRIEF OF LONG ISLAND LIGHTING COMPANY, PHILADELPHIA ELECTRIC COMPANY, AND THE UNITED GAS IMPROVEMENT COMPANY

It has been over eight years since this Court's decision in *Phillips* directing Respondent[1] to regulate the rates for natural gas sales by producers in the field.

---

[1] Reference in all cases is to Respondent Federal Power Commission.

All that Respondent points to since that time in the way of regulatory accomplishment—as distinct from promise—is a set of so-called area "ceilings" which are in large part based on field price levels resulting from years of non-regulation, and six scattered certificate and rate increase orders involving only a tiny percentage of gas moving in interstate commerce. Virtually nothing has been done about the level of prices currently charged by the major producers. At most, Respondent has been able to damp the sharp increase in field price levels, but at an ascending plateau which very probably exceeds producer costs.

Respondent's brief and its orders in *Hunt Oil Company* (discussed *infra*, pp. 11-14, 16-20) constitute virtually a confession of error as to Respondent's obligation to test the lawfulness of major producer rates so as to provide protection during the period pending the development of area rates. Thus, we shall show that Respondent in *Hunt* has conceded the *substantive* validity of every important contention made by Petitioners in this case. However, while the *Hunt* decision, if applied, could become a useful first step towards interim protection, Respondent still refuses to admit that it has any immediate obligation to test Phillips' rates during the indefinite period pending application of effective area rates. Respondent's only colorable excuse for its present refusal to regulate is, as we shall show, its alleged administrative difficulties, including the need to press forward the area proceedings. Petitioners wish to re-emphasize that they affirmatively support Respondent's area rate experiment as a possible long-range solution to many of the problems of producer rate making. However, Respondent's own actions belie its pleas of administra-

tive helplessness; and these in any case provide no adequate excuse for a failure to enforce the Gas Act at this time and in this case.[2]

1. RESPONDENT HAS NOT REGULATED AND IS NOT REGULATING PRODUCER RATES AT THIS TIME UNDER THE STANDARDS OF THE NATURAL GAS ACT

Respondent's own brief leaves no doubt that it does not intend to apply Sections 4(a), 4(b), 4(e) and 5(a) of the Gas Act to the vast majority of producer rates until such time, in the uncertain future, as area rates are actually made effective.

A. Respondent's Initial Prices are Merely Unregulated Field Prices, and No Substitute for Regulation Under Gas Act Standards

Respondent first argues (Br. 37-39) that it is currently protecting consumers by conditioning producer temporary certificates and deciding isolated permanent certificate cases[3] at or approximating "ceiling"

[2] Phillips argues in its brief (pp. 32-38) that Respondent was entitled to terminate its Section 5(a) proceeding, and to do nothing at present about the great bulk of its increased rates, because its test year costs exceeded test year revenues, citing cases such as *I.C.C. v. Jersey City*, 322 U.S. 503. This overlooks the fact that Respondent recognized (R. 329; see also R. 375-381) Phillips' revenues in 1959 and later years might well exceed its costs, but nonetheless as a matter of general regulatory policy chose to defer testing the lawfulness of its current rates pending conclusion of the area proceedings. Respondent for this reason refused to update Phillips' costs or fix its rates for the future. Petitioners challenge this decision as beyond the allowable scope of Respondent's discretion, since it has and will result in an abdication of regulatory responsibility for an indefinite period.

[3] Respondent lists only three such cases, although there have been several others. The vast majority of producer sale applications are merely authorized on a "temporary" basis at the "ceiling" price level and held in abeyance.

or "in-line" price levels. However, it has been demonstrated that Respondent's area ceilings are nothing more than the highest levels reached by field prices after six years of non-regulation,[4] and its "in-line" levels are admittedly merely fair field price levels as of a few years earlier. If further attestation to this is required, Commissioner Morgan has recently furnished it in dissenting from Respondent's recent Fifth Amendment to its SGP61-1 (R. 343[5]) establishing area ceilings (mimeo. pp. 1-2):[5]

> "In CATCO the court placed a continuing responsibility on us, in certificating procedures, to prevent 'out of line' prices and to 'hold the line awaiting adjudication of a just and reasonable rate.'
>
> "Under the terms of our statement of General Policy No. 61-1[3] we have been attempting to carry out our responsibilities through the device of so-called area prices—a currently fashionable synonym for what used to be called 'fair field prices.'"

[3] Issued September 28, 1960, 24 FPC 818."

Commissioner Ross also stated in dissenting from the same order (mimeo. p. 2):

> "The evil inherent in adopting an interim guide line price is the failure to set a standard upon

[4] See Wisconsin-New York Br., pp. 29-36 and App. B thereto. Respondent has recently reduced two of the ceilings slightly, to an "in-line" price level (see fn. 5). This level is, of course, by definition merely a fair field price test, and has never been shown to be "just and reasonable."

[5] By this Amendment, Respondent reduced the area ceiling in Texas District #4 from 18¢ to 16¢. See Resp. Br. 37. Copies of this order and the companion *Skelly* Opinion No. 362 have been furnished to the Court.

which the Commission measured the price. It is all well and good to set forth a number of factors such as 'cost information from decided and pending cases, existing and historical price structures, volumes of production, trends in production . . . .' but the important matter is what is used in practice. Or, in the language of CATCO, what is in-lineness?"

Perhaps most significant, Commissioner Ross stated in dissenting from Respondent's *Skelly* Opinion 362, issued simultaneously with the foregoing Fifth Amendment to SGP61-1 (mimeo. p. 4):

"In my view, the administrative embarrassment of a backlog and the administrative difficulties of conducting individual hearings and making decisions therein does not warrant prohibiting either the producer from seeking legitimate increases or the consumer from contesting the validity of the interim prices if such interim prices are to be the way of life for a number of years. It is hardly any consolation to either party to say 'don't worry, we will review them periodically and use our ouija board to set new prices.' I am less than enthusiastic about my expertise to conjure up a fair price without the benefit of hearings in which parties can introduce evidence of in-lineness, favored nation and triggering clauses in accordance with CATCO. Also, as Judge Fahy suggests in *Wisconsin* vs. *F.P.C.*, *supra*, in his dissent, the Commission should not be affirmed in failing to decide present cases. It is true that that case involved Section 4(e) and 5(a) proceedings but the philosophy is the same."

It is obvious that consumers are irreparably injured to the extent Respondent sanctions, even on a temporary basis, the collection of non-refundable "ceiling" prices which are later found "unjust and unreason-

able" in area proceedings. Given the genesis of Respondent's SGP61-1 ceilings, it is highly unlikely, to say the least, that they represent just and reasonable rate levels. It follows that the Commission is virtually assuring collection of unlawful rates when it permits producers such as Phillips to initiate under Section 7 and collect indefinitely millions of dollars in non-refundable high initial rates, without even the prospect of future review in Section 5(a) proceedings (see also Pet. Br. 20-25).

B. Respondent Has Decided Virtually No Rate Increase Cases

Respondent also argues that it is providing adequate protection against increased rates by orders under Section 4(e) of the Gas Act. The three Section 4(e) rate orders cited by Respondent (Br. 40-41) as an effective regulatory program from 1955 to date involve South Louisiana increases totaling $1,235,456 on an annual basis at prices largely in excess of 25 cents per Mcf. These increases constituted eight-tenths of one per cent (by annual dollar amount) of annual rates currently subject to refund which are accumulating at $158 million a year and aggregate an estimated three-quarter billion dollars (Pet. Br. 16). When it is recognized that 72 per cent of South Louisiana gas purchased by interstate pipelines (Pet's. Br. App. D-1; see also App. A, *infra*, p. 27) is sold at prices exceeding the Commission's "in-line" price[6] of 20 cents per Mcf, and that even this price has never been found "just and reasonable", it is obvious that these orders barely touch on the increased rate problem, even in South Louisiana. It follows that

[6] As determined on remand from *Atlantic Refining Co.* v. *Public Service Comm'n of New York*, 360 U.S. 378.

the approximately three-quarter billion dollars in producer revenues subject to refund continue to mount unchecked by the application of the Section 4(e) standards of the Act.

Petitioners (Br. 16-10) have pointed out that for political and economic reasons, it is improbable that very large accumulated refunds could be ordered even if the underlying rates were found unlawful. Further, the necessary teaching of this Court's *Tennessee Gas* decision (No. 48, December 3, 1962) is that Respondent will not be able to grant adequate retroactive relief under Section 4(e) of the Act against accumulated unjust and unreasonable rate increases even assuming that full refunds could be made at the conclusion of the area proceedings.

In *Tennessee Gas*, this Court sustained against constitutional objections an "interim" pipeline rate reduction order on the ground that consumers could be effectively protected only by making an immediate reduction in that portion of the pipeline's rate increase found unlawful. The fact that the increased rates were refundable in their entirety (so that any overpayments would ultimately be recovered) was held inadequate "'to protect consumers against exploitation at the hands of natural gas companies . . . .' *Federal Power Comm'n* v. *Hope Natural Gas Co.*, 320 U.S. 591, 610 (1944) and 'to underwrite just and reasonable rates to the consumers of natural gas . . . .' *Atlantic Refining Co.* v. *Public Service Comm'n of New York*, 360 U.S. 378, 388 (1959)." (Slip Op. 9.) As the Court stated:

> "* * * True, the exaction would have been subject to refund but experience has shown this to be somewhat illusory in view of the trickling down process

> necessary to be followed, the incidental cost of which is often borne by the consumer, and in view of the transient nature of our society which often prevents refunds from reaching those to whom they are due. It is therefore, the duty of the Commission to look at 'the backdrop of the practical consequences [resulting] . . . and the purposes of the Act,' *Sunray Mid-Continent Oil Co.* v. *Federal Power Comm'n*, 364 U.S. 137, 147 (1960), in exercising its discretion under § 16 to issue interim orders and where refunds are found due to direct their payment at the earliest possible moment consistent with due process. In so doing under the circumstances here the Commission's ultimate action in directing the severance and in entering the interim order was not only entirely appropriate but in the best tradition of effective administrative practice." [Footnote omitted. Slip Op. 9-10]

This holding applies axiomatically here, since pipelines pass on producer rate increases to their customers in the form of rate increase filings which are in turn passed on to consumers.[7] Since Respondent has urged and the Court has held that refunds of unlawful pipeline rates provide inadequate protection, refunds of producer rates—even if ordered and passed on by the pipelines—necessarily provide inadequate protection, and for the identical reasons.

It follows that Respondent's extended argument (Br. 42-44) that consumers are adequately protected by the possible refundability of high-level South Louisiana

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[7] As Respondent has frequently noted (e.g. 1961 Annual Report, p. 76), pipeline increases are largely the result of producer increases. Thus, the cost-of-purchased-gas increase underlying the *Tennessee Gas* rate filing in No. 48 bulked five times as large as the rate of return reduction ordered by Respondent in that case.

rates overlooks and is conclusively refuted by its vigorously argued position to the contrary in No. 48, This Term.[8]

Finally, it is by no means clear that Respondent will be able to provide even *prospective* protection against existing high-level field prices if and when the area proceedings are concluded. Present day field price levels do not present merely an "interim" regulatory problem but are rather the result of the failure to regulate for eight years. Each month that Respondent delays in attacking the charges made by major producers, such price levels become more firmly imbedded in our economy. Experience in rate or price regulation, including OPA and OPS regulation during the recent wars, demonstrates that it is impossible to "roll back" consumer prices which have become fixed and established in the economy without subsidizing persons who have paid increased production costs. Price regulators have long recognized that it is essential to "nip in the bud" price increases before the economy has had an opportunity to adapt itself to the fact of the higher price. Thus, wartime price regulation has usually sought to prevent price increases, not attempt

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[8] Respondent's (Br. 42-44) attack on Petitioners' use of Respondent's admittedly inadequate data on producer rate refundability and price distribution ignores the fact that these data are the only available usable information on these topics, and that the inadequacies of the data (plainly flagged in Petitioners' brief, pp. 22-24) are solely Respondent's responsibility. Respondent's contentions as to the refundability and price distribution of South Louisiana rates (Br. 42-44), including the statistical treatment in App. C to its brief, are examined in App. A *infra*, pp. 27-31.

to undo them retroactively.[9] Respondent, however, is proceeding on exactly the opposite assumption: that it will be able to reduce both retroactively and prospectively field price levels on which the business of producers will be built and on which the entire economy of the oil and gas industry will increasingly depend. The greater the delay in regulation the greater the likelihood that producer expectancies as to increased rates will be recognized and left undisturbed.

Respondent in its brief has necessarily admitted, therefore, that, aside from a few scattered and minor cases, its current affirmative regulatory program consists of an attempt to freeze initial prices at recent field price levels, as well as to subject some rate increases to refund liability.[10] It has not applied and does not intend to apply Sections 4(a), 4(b), 4(e) and 5(a) to the great bulk of producer rates until the day many years hence when it hopes to have valid area pricing in force.

Respondent's brief has therefore served to clarify and sharpen the primary issue before this Court: *Can Respondent's alleged administrative difficulties justify an admitted failure to apply Sections 4(a), 4(b), 4(e) and 5(a) to producers of natural gas for an indefinite period following this Court's* Phillips *decision?*

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[9] See Pegrum, Dudley F., *Public Regulation of Business*, 1959, pp. 223-225; Fainsod, Merle, et al., *Government and the American Economy*, 1959, p. 867; Wilcox, Clair, *Public Policies Toward Business*, 1955, pp. 693-694; Nelson, Saul, "OPS Price Control Standards", *Law and Contemporary Problems*, 1954, pp. 558, 570; Hardy, Charles O., *Wartime Control of Prices*, 1940, p. 14.

[10] The effect of the producer rate settlements approved by Respondent is discussed *infra*, pp. 14-16.

2. RESPONDENT'S OWN ACTIONS DEMONSTRATE THAT IT CAN PROVIDE THE VERY TYPE OF EFFECTIVE INTERIM REGULATION PETITIONERS SEEK HERE.

Turning to this issue, it is striking to note that Respondent's defense of its current regulatory inaction moves in two directions simultaneously. On the one hand, the Commission protests that it has an effective interim regulatory program, citing *inter alia* decisions in six isolated cases involving a tiny percentage of sales moving in interstate commerce, and ignoring the approximately three-quarter billion dollars in suspended increases outstanding and the vast amounts of gas now flowing at above-ceiling rates. Respondent also points to settlements reluctantly agreed to by intervenors at rate levels consistent with its area "ceilings" which, as we have seen, are almost certainly not just and reasonable rate levels.

On the other hand, Respondent argues that for administrative reasons it cannot mount more of an interim regulatory program; that it cannot give present day consumers greater current protection because it must utilize its staff to develop a regulatory program which may or may not protect future consumers.

We have already pointed out (Br. 11-15) that Respondent cannot sacrifice existing consumer interests for its own administrative convenience in developing a future regulatory program. Respondent's recent actions seem to indicate a partial acceptance of this principle.

A. Respondents' Recent Order in Hunt Oil Is Tantamount to a Confession of Error in This Case.

We have seen that Respondent's position has somewhat narrowed since its briefs in the Court of Appeals and in opposition to certiorari in this Court. Respondent no longer argues that it would be technically impossible to utilize the major producer rate cases in

order to provide interim protection against current rate levels. Indeed, it would be difficult for it to do so in the light of the numerous Examiners' Decisions recently issued deciding producer cases following Respondent's own precedent,[11] and in the light of Respondent's remand of the *Hunt* case (App. B, *infra*, p. 32; discussed further *infra*, pp. 16-19) and its announced decision actually to decide the "Section 4(e) aspect" of that particular case.

The *Hunt* decision is the second in line of a number of major producer rate cases which have reached Respondent for decision (Pet. Br., App. A, p. 33). *Hunt* amounts virtually to a confession of error on the major *substantive* points raised by Petitioners in this case. Thus, Respondent in *Hunt* has concluded that:

(1) "The use of individual company costs as a method for determining whether an independent producer's increased rates are just and reasonable appears to be necessary if we are to pass upon such rates at all prior to the establishment of area rates" (App. B, *infra*, pp. 36-37);

(2) Accordingly, it is necessary under the Natural Gas Act to determine the justness and reasonableness of Hunt's increased rates[12] tested by its individual costs, updating the 1957 test year if necessary by the introduction of current costs (App. B, *infra*, pp. 37, 39);

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[11] Copies of these unreported decisions have been supplied to the Court.

[12] With two inconsequential exceptions (R.S. 49, 50), all of Hunt's current increased rate schedules are involved in rate proceedings consolidated in its rate case, so that Respondent will necessarily determine the lawfulness of substantially all of that company's increased rates in passing on the consolidated dockets in this proceeding on the basis of current costs. See further, *infra*, p. 18.

(3) It is necessary under the Natural Gas Act to determine whether Hunt's increased rates are unduly discriminatory or preferential, regardless of whether or not its over-all revenues are supported by over-all costs (App. B, *infra*, p. 36);[13]

(4) It may prove necessary under the Natural Gas Act to test the lawfulness of Hunt's non-refundable rates in the course of passing on its increased rates; Hunt's Section 5(a) case will be held open for this eventuality (App. B, *infra*, p. 37).

This is, of course, the identical relief sought in this case, except that Respondent has deferred directing its Examiner to apply Section 5(a) to Hunt's non-refundable rates until such time as it becomes apparent that area rates will not be available for this purpose. However, it is virtually certain that Respondent will eventually have to decide the "Section 5(a)" aspects of the *Hunt* case, merely in order to be able to decide the increased rate or "Section 4(e)" aspects. We show in Part 4, *infra*, p. 23, that effective area rates cannot be expected for many years. To comply with Respondent's directive, the Examiner will be required to reduce Hunt's increased rates if he finds either (a) that its over-all revenues exceed its over-all cost of service in the test year, or (b) that the increased rates or any of them are unduly discriminatory or preferential when compared with Hunt's other rates. It will almost cer-

[13] Respondent argues (Br. 53) that the *Phillips* record would not permit an application of the Section 4(b) "discrimination" test to Phillips. If this is the case, why was Respondent not obliged to develop a record which would, as it intends to do in *Hunt*? Counsel's discussion of Respondent's obligation to apply Section 4(b) to individual high level rates (Br. 53) is at complete odds with the *Hunt* order (App. B *infra*, p. 36).

tainly be impossible for the Examiner to accomplish this if he cannot adjust the non-refundable rates under Section 5(a).[14]

Respondent (App. B, *infra*, p. 37) indicates that it intends to follow the procedure adopted in *Hunt* in other major producer cases, and that decision undoubtedly represents a forward step in interim consumer protection. However, while Respondent has conceded the validity of Petitioners' contention that these cases provide the only available means of consumer protection pending the development of area rates, it has not taken the final step of setting lawful future rates under Section 5(a) which is essential to provide that protection. We discuss *infra*, pp. 16-20. Respondent's unwillingness thus far to apply its *Hunt* procedures to Phillips' increased rates based on its current costs.

B. The Current Producer Rate Settlements Demonstrate That Individual Producer Regulation Is Feasible on an Interim Basis, But in Themselves Provide Inadequate Protection.

The recent settlements of producer rate cases relied upon by Respondent (Br. 39-40)[15] also could be charac-

[14] Hunt's non-refundable rates bulk large in Hunt's revenues, since it currently receives about 43% of its revenues under non-refundable schedules. Since the Examiner at this point cannot adjust these rates, even prospectively, it will probably be impossible for him to adjust Hunt's increased rates and thus its over-all revenues sufficiently so as to conform to the "just and reasonable" standard, which necessarily involves a comparison of Hunt's over-all costs and revenues. Further, reduction of Hunt's high increased rates to eliminate undue discrimination may require a counterbalancing increase in certain of its non-refundable rates to bring its future revenues in line with its costs. This would also be impossible under Respondent's order.

[15] Since the preparation of Appendix A to Petitioners' main brief, the *Hunt* case has been remanded, as noted above, and there have been examiners' decisions in *Gulf* and *Sohio*. Copies of these decisions have been furnished to the Court.

terized as a form of current major producer rate regulation, albeit a wholly inadequate one. In these cases, there has first been a finding by the Examiner of the producer's individual, company-wide costs of finding and producing gas, or a cost determination presented in evidence by Respondent's staff. The parties have then negotiated a settlement, setting rates for the future not on costs but following the rough outlines of Respondent's area or ceiling rates, but always with certain significant exceptions. Invariably, Respondent by approving these settlements has afforded the producer an opportunity to earn future revenues substantially exceeding the costs found by the Examiner or determined by its staff.

The cost of service determinations *have* been used, perhaps paradoxically, in determining the producer's liability to refund past payments in excess of the various settlement rate levels; i.e., the producer has been permitted by Respondent to forego such refunds in years in which its revenues did not return cost of service. This amounts, of course, to a backhanded recognition of the validity of such cost determinations.[13]

Thus, Respondent has gone three-quarters of the way toward individual company regulation pending area rate development. It has abdicated its function only at the stage of actually applying costs to derive a set of just and reasonable rates for the future. This, unfortunately, is the major purpose of regulation under the Natural Gas Act.

[13] Intervenors, such as Petitioners, have acquiesced in settlement rates in default of more effective regulatory protection. The alternative would be to continue paying indefinitely high, non-refundable initial rates, as well as rates subject to refund obligations which, as Respondent has admitted, provide no real protection to consumers.

It follows that, while Respondent in one breath is arguing that it cannot for administrative reasons utilize the major producer cases as an interim regulatory device, in the next breath, it is in fact arguing that it has done so in a manner of speaking, and that its half-way measures provide adequate protection under the Act. Petitioners agree that Respondent could protect present day consumers by deciding these cases, although they vigorously disagree that Respondent's performance thus far has been adequate. They strongly urge that this Court reinforce Respondent's belated recognition of its regulatory responsibilities by a direction to act responsibly to protect existing consumer interest.

3. IT IS MANIFESTLY POSSIBLE FOR RESPONDENT, WITHOUT CRIPPLING ITS AREA EXPERIMENT, TO USE THE EXISTING MAJOR PRODUCER CASES TO PROVIDE INTERIM REGULATORY PROTECTION. IT SHOULD BE DIRECTED TO DO SO

The place to begin such an increased effort to protect existing consumers is this case. We have noted above that Respondent has recognized that it should decide (if necessary on the basis of recent cost data) at least the 4(e) aspects of the *Hunt* rate case, the second producer case after *Phillips* to reach it for decision (App. B, *infra*, pp. 32-40). Hunt Oil Company is a small producer[17] whose rates do not loom large in the overall picture of producer rate regulation. Phillips in contrast is a giant, selling approximately 10 per cent of the gas moving in interstate commerce, and its rate levels can have a profound economic effect on all producer sales in all areas. We have seen that Phillips'

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[17] Hunt in 1960 ranked 58th in sales of natural gas in interstate commerce (*1960 Sales by Producers of Natural Gas in Interstate Commerce*, Federal Power Commission).

current Section 4(e) increases subject to refund aggregate approximately $22 million on an annual basis with a cumulative amount undoubtedly several times this figure. We have seen that Phillips' unit revenues increased more than 50 per cent since its 1956 costs were determined; and that Phillips at present is making sales at non-refundable rates which produce revenues exceeding by $3 million annually those which would be produced if its rates were consistent with Respondent's increased field price levels (Pet's. Br. 16, 22). *Hunt* in contrast involves current rate increases totaling only $254,940 annually. Hunt's sales under non-refundable rates produce revenues exceeding those which would be produced by Respondent's increased field price levels by only $85,053 per year. Despite this contrast, Respondent has refused to decide more than a trivial fraction of the 4(e) aspect of the *Phillips* case.

Respondent attempts to reconcile its action here and in the *Hunt* proceeding by arguing that much more regulatory effort would be involved in deciding the Phillips 4(e)'s than the Hunt 4(e)'s, possibly because of the relative size of the two companies (Br. 41).

Actually, *Hunt*, as Respondent's decision suggests (App. B *infra*, pp. 32-36), will involve substantially more staff effort than would even a decision limited to Phillips' outstanding rate increases. In *Phillips*, Respondent has reached a decision as to all governing principles, and needs merely to update the figures in Phillips' already determined cost of service to a more recent test year. Experience demonstrates that this need take only a few months, despite Respondent's contrary

suggestion (Br. 46).[18] *Hunt*, however, was tried prior to the *Phillips* decision and it will be necessary to apply most of the important *Phillips* principles to Hunt's particular operational and cost picture for the first time; i.e., to retry the case in some important respects.[19]

Respondent may argue that its *Hunt* and *Phillips* orders are reconcilable because it intends to grant in *Hunt* only the limited relief it granted in *Phillips*, i.e., decide only the consolidated Section 4(e) proceedings. Actually, whereas Phillips' consolidated rate increase proceedings involved only about 21% (by annual dollars) of its current sales under increased rates, the *Hunt* proceeding (as we have already noted *supra*, p. 12, fn. 12) involves at least one docket covering each of Hunt's increased rate schedules (except Rate Schedules 49 and 50 where the non-consolidated rate increases aggregate $3,200.00 a year). Thus, Respondent in deciding the consolidated dockets, will determine the "just and reasonable" and "non-discriminatory" rate level for virtually all of Hunt's increased rate schedules based on a 1957 test year updated by current costs. Respondent could hardly allow Hunt to continue to collect, under later non-consolidated, rate increase filings, rates which it had found unlawful

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[18] Phillips has supplied 1960 cost data in the Permian Area proceeding, AR61-1. Respondent's suggestion (Br. 46) that there may be changed circumstances in *Phillips* which will require attention is of course true. This does not negate the fact that the job has largely been done.

[19] Thus, the Examiner will be required to apply for the first time to Hunt's new production volumes the *Phillips* principles governing allocation of production costs and cycling and gasoline plant costs, two of the three most important cost elements—the third being exploration costs (App. B, *infra*, pp. 33-35).

when measured against current costs. It is clear, therefore, that Respondent will of necessity determine the lawfulness of virtually all of Hunt's increased rates.

The unanswered question, therefore, is why if Respondent considered it in the public interest and necessary to determine the justness and reasonableness and non-discriminatory character of Hunt's current increased rates, it did not also consider it necessary and in the public interest at least to decide the justness and reasonableness and non-discriminatory character of Phillips' current increased rates.

Additionally, while Respondent (Br. 42) unaccountably neglects to mention it, we have already pointed out that Respondent held open the Section 5(a) aspects of the *Hunt* case for possible future decision, stating:

> "The Section 5(a) aspect of the proceedings is in a different posture. There are currently pending area rate proceedings in the Permian Basin and Southern Louisiana in which a large percentage of Hunt's jurisdictional sales are the subject of investigations pursuant to Section 5(a). It is our hope that area proceedings will result in a timely determination of Hunt's rates for the future. However, in order to assure adequate protection to consumers against any unreasonably high rates of Hunt which may not be subject to an early determination on an area basis we will hold in abeyance further action on the 5(a) aspects of the case pending area rate determinations, with the understanding that 5(a) proceedings on some or all of Hunt's rates may be subject to reactivation if future circumstances should so dictate."

This is in marked contrast to the action in this case where Respondent saw no need to appraise the reason-

ableness of Phillips' many over-ceiling prices under Section 5(a), until such time, in the uncertain future, as the area proceedings are concluded.

Respondent, in view of the foregoing history, can hardly argue that it would be impossible to test the lawfulness of major producer rates pending the development of an area rate method, and we do not understand it to do so. Rather, Respondent's principal position (Br. 44-48) is that effort spent on existing producer regulation will delay or complicate its experimental area rate program, which is, as we have shown, not an adequate reason for deferring regulation indefinitely. Furthermore, Respondent nowhere answers one of Petitioners' principal contentions that application of the Natural Gas Act to major producer rates *now* will further, not hinder, the development of viable area rates.

We have shown that the energy which Respondent now expends in appraising settlements and deciding piecemeal isolated initial price and rate increase cases results in no real protection to the public. Such an effort is necessary, as two Commissioners have recognized, solely because of Respondent's failure to establish major producer system costs and rate methods so that "4(e) proceedings could be handled expeditiously and fairly pending the establishment of firm area rates without resorting to dismissal proceedings." Commissioners Ross and Morgan, dissenting, Opinion No. 369, November 30, 1962, Mimeo. pp. 5-6.[20]

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[20] An earlier order in this proceeding is cited at Respondent's brief, p. 41, fn. 28. Copies of Opinion No. 369 have been furnished to the Court.

The current fragmented regulatory effort, if applied to the actual task specified by the Act—the setting of just and reasonable rates—could offer very substantial, even if not perfect, protection to consumers during this interim period. Petitioners (Br. 26-29) have already pointed out that decision of the major producer cases would lay a foundation for a program of area rate making both by establishing costing principles which would have to be established in any case in the area proceedings, and by eliminating or minimizing the backlog of rate refund and initial price cases which now threaten to bury the area experiment in a hopeless morass of issues and data.[21] Such considerations may well have been at the back of Respondent's mind in undertaking (App. B, *infra*, pp. 32-40) to test the lawfulness of Hunt Oil Company's and other major producers' increased rates. Such a regulatory program will, of course, require Commission consideration of the records and cost of service determinations in those major cases in which hearing has been held. We have already pointed out (*supra*, p. 14, fn. 14) that it may

[21] Respondent has reported that as of June 30, 1961, there were 2,744 producer certificate proceedings and 3,838 producer rate increases pending and unresolved (1961 Annual Report, pp. 73, 79). Payments by pipelines under refundable producer rates were accumulating at the gargantuan rate of $758 million a year (*Id.* at 80). The increased producer rates lead inevitably to pipeline rate filings which consume time and attention of Respondent and its staff. Also, area proceedings are peculiarly ill-suited to the processing and decision of a multitude of refund claims which are affected or controlled by the costs and revenues of individual producers. The necessity of dealing with multiple refunds in such proceedings can only delay the setting of area rates governing rate increases and sales for the future.

well be impossible for Respondent to set lawful, nondiscriminatory rates solely for those schedules which have been increased without also adjusting high nonrefundable rates. It is perplexing, therefore, that Respondent has not seen fit to set just and reasonable rates in the *Hunt* proceeding, rather than merely to test the lawfulness of Hunt's rate increases, since the relief contemplated by Congress would involve relatively little additional effort.

Finally, it is significant that Respondent does not now contend that decision of the remaining producer cases is impossible or impractical with Respondent's existing resources. Respondent has received $1,900,000 additional appropriation for the fiscal year ending June 30, 1963, earmarked for over 100 additional staff members to be assigned primarily to producer regulation (P.L. 87-841; H. Rep. 1923, 87th Cong., 2d Sess., p. 10). Since a majority of the major producer cases are virtually completed, the major burden on the staff is past, so that it is free to devote the bulk of its manpower to the area proceedings. Any additional staff effort in those individual cases not yet completed will be greatly simplified by Respondent's restatement and clarification of regulatory principles in its recent *Hunt* opinion (App. B, *infra*, pp. 32-40).

It is, of course, possible that an *effective* interim regulatory program will require somewhat more staff and Commission attention than the current policy of fostering "settlements" at going price levels, plus occasional *ad hoc* decisions involving isolated rate schedules. Even if this proved the case, that would not, as we have pointed out (Br. 11-15), provide a legal justification for failure to regulate for a long period, since Respondent's discretion extends to selecting a method of regulation, but not to the decision to regulate *vel non*.

4. A MINIMUM OF FOUR TO SIX YEARS WILL BE REQUIRED TO FIX EFFECTIVE AREA RATES IN THE PILOT AREA PROCEEDING

Finally, Respondent argues (Br. 46-48) that even assuming consumers may be injured by its policy of deferring producer regulation under Sections 4 and 5(a) of the Act, such an injury will be short lived and thus justifiable because the "pilot" area rate cases involving the Permian Basin and South Louisiana will be concluded within a year or two. This carries with it the implication that Respondent's orders setting rates for the future and directing refunds of past amounts collected in those and other areas can be made effective so as to grant substantial consumer relief within this period of time. The actual state of these proceedings does not support any such implication, and demonstrates that no relief can reasonably be expected within that time period. It is barely possible, although highly improbable, that Respondent might be able to issue an order in the Permian Basin proceeding early in 1964. However, that case has just entered the cost phase, since the hearings to this point have been confined solely to examination of general economic issues. The proceeding must go through its most important hearing phase on costs and specific regulatory methods, briefs to the Examiner, a decision by the Examiner, exceptions to, and a decision by, Respondent. In view of the complexity and unprecedented nature of the case, the many unresolved issues, and the many important interests involved, it is unlikely in the extreme that Respondent could issue a decision in this case in much under two years. The South Louisiana case, Respondent's so-called "pilot" case, has not yet been noticed for hearing and is thus much further down the road.

Even more important, Respondent completely overlooks the high probability that rehearing will be sought in these pilot cases and that they will be taken to court. Respondent recognizes this fact in its decision in this case (R. 267); and it is, of course, utopian to assume that every party in these proceedings will be satisfied with Respondent's order. An appeal is virtually a foregone conclusion and such an appeal, including the inevitable petition for certiorari to this Court, can be expected to consume not less than eighteen months *if* certiorari is denied.

It follows that no actual rate reductions *can be expected* in the first pilot area rate proceeding in under three to four years. And this schedule, moreover, implies that there will be no unusual delays or difficulties encountered in concluding and deciding the proceeding, which is also an improbable assumption. Thus, a four year period is probably an unrealistic minimum. Furthermore, the Permian Basin is merely one of Respondent's fourteen gas pricing areas (R. 343), and one of the less important. No area program can become effective until Respondent has held hearings on and issued decisions based at least in part on the conditions in these various areas, including the all-important South Louisiana, Texas Gulf Coast and Panhandle-Hugoton production areas.

Finally, it is also improbable that Respondent could make its new regulatory program effective across the board, and order refunds of large sums of money and prospective adjustment of rates, until such time as constitutionality and lawfulness of the entire program have been authoritatively determined. Since major producers typically sell gas in most or all of Respond-

ent's pricing areas, the lawfulness of Respondent's method as applied to such producers will require comparison of the rates set in the various areas. Hence, the final judicial appraisal of the area approach will in all probability have to await the development of rates for all of the areas, which will be a lengthy process. It follows that the actual period of time consumed in deciding, applying and reviewing the most important area cases will certainly be far longer than four years. This is why the court below recognized, as it did, that the total time period was likely to be from four to fourteen years. It is Respondent's two year estimate (Br. 47) which is "highly unrealistic" in the light of the administrative realities, not that of the court below and these Petitioners.

Hence, existing consumers face at the very least an additional four to six years of non-regulation before Respondent's experimental rate program can merely *begin* to be made effective, more than a decade after *Phillips*.

CONCLUSION

For these reasons, as well as those set forth in Petitioners' main brief, it is respectfully requested that the opinion below be vacated, and that the Court of Appeals be directed to remand the cause to Respondent with instructions to reopen the proceedings, determine the lawfulness of Phillips' current rates and set future lawful rates, and order refunds of any amounts unlaw-

fully collected during past periods under those rates subject to refund.

Respectfully submitted,

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APPENDIX A

Respondent's brief (pp. 42-43) attacks both the accuracy and significance of the data contained in Appendices D-1 and D-2 of Petitioners' brief. This criticism completely ignores the significance of these data both absolutely and in the context of Respondent's available records and other data sources. The two appendix tables will be discussed separately.

Appendix D-1

This appendix reports the distribution of average prices paid for natural gas by interstate pipelines in South Louisiana in 1960 taken from the pipeline Form 2 reports on file with Respondent. These reports are the only complete source of this data.[1] Respondent correctly points out that interstate pipelines purchasing gas in South Louisiana sell a certain amount of it within that state, and in consequence certain of the volumes reported on Appendix D-1 represent non-jurisdictional transportation and sale of gas. However, the pipelines do not always identify such volumes in their Form 2 reports. It should be emphasized that since there are no other usable data which segregate the non-jurisdictional gas purchases, these are the *only* data available showing the distribution of prices paid by interstate pipelines in South Louisiana.

Assuming their accuracy, the price distribution data on Appendix D-1 are highly significant, since they show that 90 per cent of gas purchased by interstate pipelines in South Louisiana is now flowing at prices which exceed the

[1] Data supplied by the producers on Form 301 reports could in theory be used to isolate certain but not all non-jurisdictional sales, but since these data have not been compiled or abstracted by Respondent, and omit producers selling less than two billion cubic feet a year, it would be impracticable to attempt to utilize them both from the standpoint of accuracy and expense. Respondent's own published data on producer price distribution are derived from the Form 2 reports, not the 301 reports. (*Direct Sales by Producers of Natural Gas to Reporting Interstate Pipeline Companies*, 1956-1960; showing distribution by state and producer size groups).

Commission's increased ceiling price in that area, so that this ceiling price has become a dead letter.

Respondent argues (Br. 43), however, that the inclusion of the unidentified non-jurisdictional volumes makes these figures suspect and hence valueless. The fact is that the general level of intrastate prices in South Louisiana, as well as in other producing areas, is below the interstate price level, so that exclusion of intrastate volumes from the Appendix D-1 table would undoubtedly result in a higher average price, not in a lower average price. For example, if the volumes which are specifically identified in the Form 2 reports as intrastate are excluded from the data now appearing at Appendix D-1, the weighted average price increases from 20.57 cents per Mcf to 20.82 cents per Mcf. The weighted average price of the intrastate volumes thus excluded is 19.34 cents per Mcf.

Price Class	Intrastate[1] Mcf	Intrastate[1] Per Cent of Total	Other than Intrastate[1] Mcf	Other than Intrastate[1] Per Cent of Total
(Cents per Mcf)				
6.00- 6.99	0	0.00%	2,221,736	0.13%
7.00- 7.99	0	0.00	666,642	0.04
8.00- 8.99	21,878,503	6.33	1,431,176	0.08
9.00- 9.99	256,584	0.07	38,554,664	2.27
10.00-10.99	14,748,724	4.27	20,965,550	1.23
11.00-11.99	31,323,511	9.06	8,918,881	0.53
12.00-12.99	1,921,127	0.56	777,128	0.04
13.00-13.99	95,183	0.03	400,485	0.02
14.00-14.99	1,026,137	0.30	1,644,393	0.10
15.00-15.99	8,906,643	2.58	29,076,052	1.71
16.00-16.99	1,248,808	0.36	4,014,874	0.24
17.00-17.99	637,491	0.18	42,186,210	2.48
18.00-18.99	43,657,332	12.63	136,784,494	8.05
19.00-19.99	2,827,043	0.82	156,089,328	9.19
20.00-20.99	27,959,103	8.09	224,432,610	13.21
21.00-21.99	47,399,431[2]	13.71	289,783,822[3]	17.06
22.00-22.99	78,618,982	22.74	323,520,044	19.05
23.00-23.99	20,362,588	5.89	403,077,942	23.73
24.00-24.99	42,865,950	12.40	13,964,833	0.82
Total	345,743,140	100.00%	1,698,519,962	100.00%
Purchases above 21.25c	187,663,160	54.28%	940,664,076	55.38%
Weighted Average Price	19.34c		20.82c	

[1] Intrastate includes all gas identified as intrastate on the Form 2 reports and gas purchased by Olin Gas Transmission Co.

[2] 45,845,644 Mcf in this price class sold for more than 21.25 cents.

[3] 200,101,257 Mcf in this price class sold for more than 21.25 cents.

Source: Form 2 Reports, Year ended December 31, 1960.

It is also significant that 54.28 per cent of the identifiable intrastate volumes moved at prices above 21.25 cents, while 55.38 per cent of the other volumes moved at prices above that level. The reason for this close correspondence in two price levels can be found in the economics of the industry. Since the interstate market today represents roughly three-quarters of total Louisiana marketed production (Bureau of Mines Minerals Yearbook, 1960, Vol. II, p. 323), the going interstate price determines the market and acts as a ceiling on intrastate sales. As a result, intrastate prices tend to follow interstate levels, although lagging slightly behind them.

This general conclusion is supported by an uncontroverted study made by the producer witness Foster in the well-known CATCO proceeding[2] (Schedule 38 of Exhibit 12, Docket No. G-11024, *et al.*) which showed that in 1958 the average price paid for gas under all intrastate Louisiana contracts entered into in the years 1952 through 1958 was 17.34 cents per Mcf, and the average price for all interstate Louisiana contracts executed during the same period was 18.65 cents per Mcf. It is virtually certain, therefore, that if data were available permitting the segregation of interstate volumes, both the average price and price distribution of interstate sales would approximate that in Appendix D-1, except that the averages would be somewhat higher, rather than lower. Since these facts were readily available to Respondent and its staff, it is puzzling that it attempts to discredit the significance of the only available price distribution data for South Louisiana sales.

Appendix D-2.

Respondent also criticizes the Form 2 data compiled in Appendix D-2 of Petitioners' brief, and reworks this data in its Appendix C. Appendix D-2 attempts to approximate the volumes sold in 1960 by the 43 independent producers

[2] On remand from this Court in *Atlantic Refining Co. v. P.S.C. of New York*, 360 U.S. 378.

with active rate cases at prices above 21.25 cents per Mcf—Respondent's initial price ceiling—which are probably not subject to refund. This appendix was prepared utilizing data in the Form 2 reports filed by pipelines purchasing in South Louisiana for the year ended December 31, 1960, the only publicly available data of this kind (*supra*, p. 27, fn. 4). Petitioners were careful to point out (Br. 24, fn. 9) that these figures were only rough approximations, since the Form 2 data in many cases do not permit the segregation of interstate and intrastate sales. Respondent, by writing to the producers involved in such instances, has been able to determine that certain of the volumes which were not identified as being made under jurisdictional rate schedules in the Form 2 reports are actually subject to refund obligation. Respondent was also able to ascertain by writing to the producer involved that certain sales made by Olin Gas Transmission Company which were not identified in the Form 2 reports were intrastate in nature.[3]

Respondent's Appendix C as adjusted shows that approximately 44 million Mcf of gas were sold by 13 producers in South Louisiana in 1960 at prices in excess of 21.25 cents not subject to refund. Assuming an average price for these sales of 22.5 cents per Mcf, consumers were being charged in that year in excess of one-half million dollars over Respondent's current South Louisiana ceiling

[3] Respondent points out that part of these sales are identified as intrastate at pages 102 and 103 of Olin's Form 2 report. Those pages contain Olin's report on "Natural Gas Reserves Available from Purchase Agreements", and certain of the contracts listed have an asterisk footnote indicating "intrastate in nature". The total sales in 1960 under all such asterisked contracts for those producers included in the group of 13 is 27,981,383 Mcf instead of the 31,851,952 Mcf used in Appendix C, footnote 1. The difference, amounting to 3,870,569 Mcf, is a sale by Texaco shown on page 103, line 38 without an asterisk. Obviously, therefore, Respondent either made an error in its compilation or used an unidentified source for determining that the Texaco sale was in intrastate commerce.

price of 21.25 cents per Mcf which they will never be able to reclaim. Thus, Respondent's own recomputation of the Form 2 data demonstrates that substantial volumes of gas are moving at high non-refundable rates in South Louisiana, bearing in mind that these volumes relate only to the 13 major producers having active rate cases, and are confined only to this single producing area. Petitioners' main contention, of course, is that even the availability of refunds does not provide adequate protection to consumers, since it may be practically impossible to insure that refunds are actually made or reach consumers which have paid the unlawful rates. This contention has since been adopted by Respondent and this Court. *Tennessee Gas Transmission Co.* v. *F.P.C.*, No. 48, December 3, 1962.

Respondent in its Appendix C also attempts to adjust the 1960 Appendix D-1 data to reflect the results of certain producer rate settlements entered into in subsequent years after the preparation of Appendix D-2. This generates a meaningless figure since Respondent is attempting to apply 1962 prices to 1960 sales data, ignoring the fact that more gas may well have been sold at prices above 21.25 cents in 1962 than in 1960, even taking into account the fact that between those two years some prices were lowered due to settlement agreements. Thus, Respondent's records show that sales have been made at prices above 21.25 cents under South Louisiana rate schedules not in existence in 1960, and there have been subsequent increases in volumes under 1960 South Louisiana high price contracts. Obviously, it is necessary to look at 1962 sales at 1962 prices to determine how much gas is flowing in 1962 at above 21.25 cents, not 1960 sales at 1962 prices. Accordingly, the data set forth in the last two columns of the tabulation on Appendix C are meaningless.

APPENDIX B

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Before Commissioners: Joseph C. Swidler, Chairman, Howard Morgan, L. J. O'Connor, Jr., Charles R. Ross, and Harold C. Woodward.

G-9065, G-9568, G-10414, G-11124, G-11360, G-13157, G-13191, G-13468, G-13504, G-13530, G-14082, G-14408, G-16422, G-16479, G-16639, G-18464, G-18555, G-18668, G-19755, G-19869, G-20009, G-20531, R160-202

HUNT OIL COMPANY

G-16644, G-16927, G-19756, G-20532

HUNT OIL COMPANY (Operator), *et al.*

G-18092

HUNT OIL COMPANY AND H. L. HUNT

Opinion No. 365

Opinion and Order Remanding Proceedings and Severing Proceeding

(Issued October 17, 1962)

SWIDLER, Chairman:

These proceedings involved a general investigation of Hunt Oil Company's rates which was ordered by the Commission under Section 5(a) of the Natural Gas Act. Consolidated therewith are 26 of Hunt's increased rate filings suspended under Section 4(e). On October 2, 1961, the presiding examiner in these proceedings issued an intermediate decision dismissing the 5(a) proceedings against Hunt and allowing all of the proposed increased rates.

The hearings in these proceedings were held in 1959 and the final briefs were filed with the examiner shortly before issuance of our Opinion No. 338 on September 28, 1960, in the *Phillips* case, Docket No. G-1148, 24 FPC 537, affirmed

Wisconsin v. *F.P.C.*, 303 F. 2d 380 (CADC), cert. granted, 369 U.S. 870. Various cost of service studies of the company were submitted during the hearings: five by Hunt, one by the Commission staff, and one by a group of intervenors. In addition, the Commission staff submitted a recommended rate design based on its own cost studies, and Hunt introduced a substantial amount of evidence on field prices and economic factors.

We have carefully examined the evidence of record and are forced to conclude that on this record Hunt has not justified its proposed increases because it has failed to submit evidence that will permit a proper determination of Hunt's jurisdictional rates. However, since the record was made prior to *Phillips*, when few guideposts had been laid down, we will remand the case to the examiner in order to give Hunt further opportunity to shoulder its burden of proof by introducing evidence solely on the items discussed herein in which we find the record deficient. Such evidence shall be restricted to data for the test year utilized in the present record. Other parties to the proceeding may also submit evidence under the same limitations if they so desire.

The only gas volumes of record for use in making an allocation of joint production costs are sales volumes. The relative cost method for allocating production costs which we approved in principle in *Phillips* and reaffirm herein requires the use of the volumes of oil and gas produced at the wellhead which Hunt has failed to put in evidence. Actual production data are also necessary to ascertain the Btu's at the wellhead for application of the modified Btu method for the allocation of exploration and development costs, which method we also reaffirm herein.[1]

[1] We make clear that allocations on the basis of unadjusted physical units of measurement of the type presented by Hunt herein are unacceptable except for processing costs. In addition to *Phillips*, supr., see *Continental Oil Company*, Opinion 351, issued January 22, 1962.

In establishing the single product oil and gas costs for Hunt, it appears that it will be necessary to include some gas condensate production in the gas leg in order to ascertain a normal reasonable cost to procure gas alone, as Hunt has only six dry gas properties. This was done in *Phillips* where it appears that a gas to oil ratio of 100 to 1 was used to determine a cutoff ratio for the condensate wells to be included. We realize that a cutoff ratio which gives a representative portion of the total gas production for one company may not necessarily be applicable to another company. However, only the minimum number of condensate wells necessary to obtain a representative portion of Hunt's gas production should be included in the gas leg, and the condensate wells so included in the gas leg should also have an allocation of the joint production costs made to the liquids. In establishing an oil leg only those oil wells from which no sales of gas are made should be included. Non-producing properties should not be included in ascertaining the gas and oil legs for allocation of the joint production costs.

Another point we find difficult to ascertain is the effective state production tax rate which should be employed in the cost of service determination. It appears from the exhibits that an amount of 1.9¢ per Mcf for all of Hunt's gas sales was applied for a test year of 1957. No taxes in 1957 appear to have been as high as the overall rate used.

It is impossible from the record to make a proper allocation of the cycling and gasoling plant costs. We made it clear in *Phillips* that all liquid extraction costs should be assigned directly to liquids and that the remaining gathering and processing costs should be allocated on a volumetric-Btu basis between the liquids and the gas. It is, of course, necessary to have the details as to the sources of the plant inlet volumes as well as sales volumes to make this allocation, and also to have the plant operations, costs and investments properly segregated and functionalized in

order to allow the examiner to ascertain at what point gathering and processing ends and extraction begins.

An additional item upon which the evidence is deficient concerns the disputed increase put into issue by Texas Eastern in Docket No. G-18092. Involved is the question of the contractual basis for the increase. We find no affirmative showing on the record that this increase was filed pursuant to the redetermination or favored-nation clauses in the contract, but as the case is being remanded we will give the examiner an opportunity to pass upon the issue in the first instance. Also, the examiner's findings as to the justness and reasonableness of Hunt's increased rates in Docket Nos. G-18464 and G-18555 are necessarily subject to a determination as to the contractual basis for the filings, such issue now being before the Commission on exceptions to the examiner's decision in Docket No. R161-515.

The principles noted above in our requirements for additional evidence adequately answer a number of points raised by the various exceptions to the examiner's initial decision in this proceeding. The other principal points raised in the exceptions involve the examiner's findings with regard to federal income taxes, allowances for "lease plays", rate of return, accounting methods and the weight to be accorded economic evidence.

Our examination of the record indicates that no further evidence is necessary to reach a decision with regard to these points. It appears that the examiner used the economic evidence in determining his rate of return and may also find it useful on the issue of the reasonableness of specific rates, which we discuss below. He could not, of course, use such evidence as a part of a mathematical determination of the actual cost of service. The question of the inclusion of federal income taxes is well settled, *Continental Oil Co.*, Op. 351, issued 1/22/62 and *El Paso Nat. Gas Co.* v. *F.P.C.*, 281 F. 2d 567, cert. denied 366 U.S. 912.

Since the examiner used a year-end rate base for Hunt, and we believe this is correct as long as year-end unit rev-

enues were also considered, there appears to be no need for a "lease play" allowance. In addition to the fact that Hunt did not adequately identify all of its sources of capital, any money actually expended to obtain leases during the test year would receive a full year's return through the use of a year-end rate base, even though some of the properties may have been purchased late in the test year.

The use of venture or asset accounting in ascertaining Hunt's cost of service has been made an issue, but it appears from this record that the actual difference in the amounts involved is very small. While we do not now hold that asset accounting is improper, we see no reason in this proceeding for departing from the venture accounting method which Hunt has always followed.

In addition to obtaining additional evidence and ascertaining a proper cost-of-service for Hunt it will also be necessary for the examiner to receive evidence and make findings as to whether the individual increased rates here in issue are just and reasonable. Our examination of the record in this case convinces us that increased rates for specific sales cannot always be found to be just and reasonable solely on the basis of a comparison of individual company-wide costs with that company's revenues in a test year. The mere fact, if it turns out to be a fact, that company-wide overall unit costs for the test period are greater than comparable unit revenues cannot justify all specific rate increases no matter how high they may be; the deficiency may well result from the fact that other sales are made at rates below that which could be justified on a cost basis. In any event consumers should not necessarily be obligated to make up overall revenue deficiencies by paying rates which are higher than those prevailing in the production area where this higher price cannot be individually justified.

The use of individual company costs as a method for determining whether an independent producer's increased rates are just and reasonable appears to be necessary if

we are to pass upon such rates at all prior to the establishment of area rates. Cost-of-service was the method which was used in this proceeding and others pending before the Commission prior to the commencement of the area rate proceedings and, as we have previously indicated, we intend to continue to process and decide such proceedings as promptly as the record in each case permits. We believe that the record in these proceedings, as supplemented on remand, should provide a basis for determination of the justness and reasonableness of Hunt's section 4 increased rates at the time they became effective.

The Section 5(a) aspect of the proceedings is in a different posture. There are currently pending area rate proceedings in the Permian Basin and Southern Louisiana in which a large percentage of Hunt's jurisdictional sales are the subject of investigations pursuant to Section 5(a). It is our hope that area proceedings will result in a timely determination of Hunt's rates for the future. However, in order to assure adequate protection to consumers against any unreasonably high rates of Hunt which may not be subject to an early determination on an area basis we will hold in abeyance further action on the 5(a) aspects of the case pending area rate determinations, with the understanding that 5(a) proceedings on some or all of Hunt's rates may be subject to reactivation if future circumstances should so dictate.

The Commission orders:

For the reasons stated, the proceedings in Hunt Oil Company, Docket Nos. G-9065, *et al.* are hereby remanded to the examiner for further hearing directed to the issues on which the evidence of record is deficient and issuance of a decision in conformity with this order, except in Docket No. G-10414, which is hereby severed from the consolidated proceedings.

By the Commission.

JOSEPH H. GUTRIDE,
Secretary.

Order Denying Petition for Reconsideration and Severing Proceeding

(Issued December 10, 1962)

On November 14, 1962, Hunt Oil Company filed a Petition for Reconsideration[1] of our Opinion No. 365, issued October 17, 1962, in which we remanded these proceedings to the presiding examiner for the reception of additional evidence and issuance of a new intermediate decision.

The main thrust of Hunt's petition is that our *Phillips* decision, Docket No. G-1148, 24 FPC 537, affirmed *Wisconsin* v. *F.P.C.*, 303 F. 2d 380 (CADC), cert. granted, 369 U.S. 870, was in many respects either incorrect in principle or inapplicable to the Hunt Oil Company. Hunt has apparently misread our order remanding these proceedings. On the existing record Hunt had not sustained its burden of proof but in the special circumstances of this case which was tried before our *Phillips* decision we remanded the case to the examiner to give *Hunt* a further opportunity to sustain its burden. Our remand order does not preclude Hunt from introducing evidence to substantiate its claim. On the contrary, the purpose of remanding the case rather than dismissing Hunt's rate increases was to afford Hunt precisely that opportunity. Hunt, of course, is free to renew any arguments it may have, based on the existing evidence and the additional evidence to be adduced, to convince us that in some respects the *Phillips* decision should not be followed.

In its petition Hunt has also argued that we should not have severed the 5(a) proceeding from the 4(e) proceedings and that it should not be limited to a 1957 test year.

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[1] Hunt's filing is entitled "Application for Rehearing"; however, under Section 1.34 of our Rules of Practice and Procedure, an Application for Rehearing may only be filed to a final order. As our Opinion 365 remanding these proceedings for further evidence cannot possibly be construed to be a final order, we are treating Hunt's filing as a petition for reconsideration.

The Commission is, of course, free to initiate a Section 5(a) proceeding against Hunt at any time so that Hunt is not prejudiced by our action in not terminating the Section 5 docket. The question concerning the propriety of a 1957 test year in a Section 5(a) proceeding would be appropriate if the proceeding is reactivated and is therefore premature.

In limiting the evidence to a 1957 test year with respect to the Section 4(e) cases, it was our intent to expedite a final determination in this already prolonged case. The 1957 year appears to be a proper test year for the Section 4(e) dockets at issue, most of which were filed shortly thereafter and have been superseded by other increased rate filings. If Hunt believes that its 1957 data are so unrepresentative of later periods as to override its desire for expedition of the proceedings, it may demonstrate that fact by introduction of complete data as to other year or years.

Our Opinion No. 365 did not determine any of the issues in these proceedings but indicated those issues on which the record was adequate and those which required further evidence. Hunt has also indicated the situation has changed with regard to the contractual basis for its filing in two of the dockets from that set forth in Opinion 365. If Hunt's allegations are correct, the examiner will, of course, so find in issuing his new decision on the remanded proceedings. With regard to Docket No. G-18092 it appears that it involves rates for another seller, H. L. Hunt, as well as Hunt Oil Company and the rates cannot properly be determined in these proceedings.

The Commission orders:

(A) For the reasons set forth above the Petition for Reconsideration, styled as an Application for Rehearing, filed by Hunt on November 14, 1962, in these proceedings to the extent not herein granted is hereby denied.

(B) Docket No. G-18092 is hereby severed from these proceedings.

By the Commission.

JOSEPH H. GUTRIDE,
Secretary.

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No. 73

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In the Supreme Court of the United States

OCTOBER TERM, 1962

PEOPLE OF THE STATE OF CALIFORNIA AND PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA,
Petitioners,

vs.

FEDERAL POWER COMMISSION, PHILLIPS PETROLEUM COMPANY,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

Reply Brief for Petitioners

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No. 73

In the Supreme Court of the United States

OCTOBER TERM, 1962

PEOPLE OF THE STATE OF CALIFORNIA AND PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA,
Petitioners,

vs.

FEDERAL POWER COMMISSION,
PHILLIPS PETROLEUM COMPANY,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

Reply Brief for Petitioners

In accordance with Rule 41(3) of the Revised Rules of the Supreme Court of the United States, the petitioners, the People of the State of California and the Public Utilities Commission of the State of California (California), submit this brief in reply to the brief for the respondent Federal Power Commission (Commission), and to the brief for the respondent Phillips Petroleum Company (Phillips).

ARGUMENT

I.

A Lawful Method of Regulation Cannot Be Discarded Now for Another Method Which May or May Not Become Effective at Some Uncertain Time in the Future

This controversy involves the exercise of unsolicited administrative action, affirmed by the Court of Appeals, whereby the Commission, though judicially commanded to regulate the rates of independent producers of natural gas, ceased to regulate those rates under lawful procedures, issugd the Policy Statement by administrative fiat as an interim substitute for regulation, and directed the energies of its personnel to exploring the concept of natural gas priced as a commodity on an area basis. Whether the Commission ever establishes area rate regulation (in some form or other), or whether, if established, such a scheme is approved or cast aside upon appeal, the method remains at the moment only a vision. Yet far from visionary have been the immediate consequences of the Commission's pursuit in the instant case of this long range objective.

The Commission, through its *Phillips* opinion, rejected the individual company cost of service approach for producer regulation (R. 256-269) and elected to be guided by a statement of prices established without notice, hearing or the taking of evidence (R. 325). A lawful and established means of evaluating producers' rates—designed to protect both the consumer and the industry—was abandoned, a temporary method fraught with legal and practical infirmities was substituted, and consumer interests were placed in abeyance to await the result of the area rate experiment.

California cannot comhrepend why the Commission did not follow conventional procedures in this *Phillips* case. The Commission, if so inclined, might have decided this matter with a finding that the rates at issue were just and reasonable, leaving those parties aggrieved by such finding to seek review. At the same time, while continuing to regulate producers on a cost

of service basis, it might have conducted proceedings relative to area rates—giving notice, requesting comment, holding hearings and taking evidence. No rejection of existing procedures would have been necessary; no Policy Statement would have been required. The Commission, instead, chose the unconventional course of termination without decision and of regulation by decree.

The explanation offered by the Commission for its unorthodoxy is an asserted obligation to devote its energies and those of its staff to the development of the new technique. (Com'n Br., pp. 32, 44). While it is not known how many staff members actually are engaged in the area program, California, as a sister regulatory commission, is aware of the enormous work-loads which sometimes are placed upon agency personnel. Nevertheless, a need for additional personnel certainly could have been anticipated sometime during the period from this Court's mandate to regulate in 1954 to the issuance of the opinion in 1960. A concurrent area rate investigation might even have been initiated with a limited staff at an earlier date. Moreover, if a vigorous program of regulation along conventional lines had been instituted in 1954 there might be no need today for staff assignments in the area rate field. (Calif. Br., pp. 23-29). Whatever the case, the Commission's shift in employees' duties cannot justify now the very acts which prompted the change—the rejection of cost of service and the promulgation of the Policy Statement.

If the Commission's concept of ultimately pricing gas as a commodity materializes, the question of whether such is a proper method of regulation under the Natural Gas Act and the *Hope*[1] case unquestionably will be before the courts. (Com'n Br., pp. 17-25). However, the present the realities of the situation prohibit directing all attention to the final end which the Commission desires. For if it is assumed, for purposes of argument, that the area price method is neither finally adopted nor approved, the Commission will have wasted irreplaceable time and resources

1 *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

to the detriment of the consumers who were entitled to continuous regulation. Even assuming that the area rate objective finally is attained, where will this leave the consumers who were denied lawful regulation during the interim period of development?

There is an important and yet unanswered question: With the commodity pricing of gas still only a notion, why did the Commission abandon years of experience with lawful and established procedures and proclaim a form of regulation by administrative fiat which prejudges the outcome of the commodity approach?

The Commission's brief makes no attempt to reply to California's arguments that the Policy Statement is fraught with legal and practical infirmities which make it an unlawful and ineffective form of regulation. (Calif. Br., pp. 48-55). Rather, the Commission asserts that it could not effectively regulate under existing procedures and that *something* had to be improvised for interim use until area rates were developed upon records in proceedings designed for that purpose. (Com'n Br., pp. 25-30, 35-37).

The Commission offers several reasons for its immediate abandonment of cost of service regulation. They are: (1) the absence of a correlation between a producer's investment input and his marketable output (Com'n Br., pp. 25-27); (2) the possibility that royalty owners might lease only to high cost producers (Com'n Br., p. 27); (3) the chance that gas from the same well might sell at varying prices depending upon who is selling the gas (Com'n Br., pp. 27-28); (4) the difficulties of allocating production and exploration costs between gas and oil (Com'n Br., pp. 28-29); (5) the futility of a cost approach when estimates of reserves are imprecise and income tax problems are complex (Com'n Br., p. 29, note 16); and (6) the administrative burden of holding repeated rate cases for each of the thousands of producers (Com'n Br., p. 29).

All of the above, with the possible exception of (6), are issues which the Commission and the courts have resolved in numerous pipeline company rate cases where questions of production as well

as transmission of natural gas were presented. See *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944); *Colorado Interstate Gas Co. v. Federal Power Commission*, 324 U.S. 581 (1945). The issues (1), (2) and (3) are based on erroneous facts and unsupported assumptions (Calif. Br., pp. 42-44), and are concerned not with the Commission's broad responsibilities but rather with relationship problems which may or may not develop among co-producers and royalty owners. Phillips, the party that might have been expected to raise these issues, is conspicuously silent respecting them.

There remains for further consideration the alleged administrative burden of cost of service regulation. First, the examiner found that "the length and complexity of the instant *Phillips* proceeding cannot fairly be regarded as representative of the situation which will be commonly encountered in future rate proceedings * * *." (R. 65). Secondly, since the issuance of the *Phillips* opinion, the Commission and its examiners have continued to use the cost of service approach, in cases pending at the time of the opinion, with no indication of undue hardship. (Calif. Br., pp. 40-42). As one examiner recently expressed himself in such a proceeding:

> "The valuable lessons will flow directly from the fact that individual cases, through a more thorough churning of facts, claims and counterclaims, will enable the Commission to sort things out; make them clear; and keep them simple. Moreover, action in individual cases makes regulation a present reality rather than a distant hope, with each new case being approached with a background of progress and greater perspective." *Gulf Oil Corp.*, Docket No. G-9520, September 24, 1962 (Mimeo, p. 6).

Finally, any administrative burden in rate cases can be met by an application of self-help, such as requiring uniform accounts and records, as California has urged,[2] and by the expedition of hearings and decisions.

2 Petition to Establish a Uniform System of Accounts and Records for Independent Producers of Natural Gas, Docket No. R-220, (Calif. Br., pp. 26-27).

The rejection of cost of service certainly cannot be substantiated on the record in this proceeding which was developed along such lines. Yet this rejection was the motivating factor in the Commission's order of termination. (Com'n Br., p. 31). If the Commission had recognized cost of service as an acceptable premise for determining Phillips' rates, then this case could have been decisively concluded. Clearly this record demanded such recognition.

The impact of the rejection of cost of service lies not only in the termination of this proceeding but also in the creation of a hiatus in producer regulation. If the Commission had directly substituted a lawfully established area rate program upon the abandonment of cost of service, then California could not complain, whatever be its opinion of such program. But for the Commission to abandon prematurely this existing procedure when commodity pricing was only a theory with divided support, was a serious error.

The significance of this error was compounded by the Commission's unexpected promulgation of the Policy Statement. Like the rejection of cost of service, the Policy Statement motivated the Commission's termination of the instant proceeding. Even the Commission itself would have found termination impossible unless some substitute was provided simultaneously whereby it could oversee Phillips' rates. (R. 325). Undoubtedly, this is why the court below, in affirming the act of termination, attached so much importance to the Policy Statement. (R. 421-426). Yet the Policy Statement, while influencing the Commission's order of termination, served also as an instrument enabling the Commission to abandon lawful cost of service regulation before a lawful new method had even been devised.

Until the opinion in the instant proceeding, rate matters under the Natural Gas Act were handled by the procedure of notice, hearing and the taking of evidence. With the Policy Statement the Commission for the first time set rates based on what in its opinion the prices should be and, admittedly, not on what was just and reasonable in the statutory sense. It was never intended that a regulatory agency should have such power. This Court has

stated strongly that agencies, at least in rate matters, cannot act in such omnipotent fashion. In *Interstate Commerce Commission v. Louisville & Nashville R.R.*, 227 U.S. 88 (1912), the agency set aside certain rates because it was of the *opinion* that the rates were unreasonable. On review, the Government urged that an order based on such opinion was conclusive even without substantial supporting evidence. This Court rejected the contention and stated, at page 91:

> "But the statute gave the right to a full hearing, and that conferred the privilege of introducing testimony, and at the same time imposed a duty of deciding in accordance with the facts proved. A finding without evidence is arbitrary and baseless. And if the government's contention is correct, it would mean that the Commission had a power possessed by no other officer, administrative body, or tribunal under our government. *It would mean that, where rights depended upon facts, the Commission could disregard all rules of evidence, and capriciously make findings by administrative fiat.* Such authority, however beneficiently exercised in one case, could be injuriously exerted in another, is inconsistent with rational justice, and comes under the Constitution's condemnation of all arbitrary exercise of power." (Emphasis supplied).

II.

Section 5(a) and Section 4(e) Are Both Designed to Reach Results which Afford Protection for Consumers

In this proceeding there is no need to make fine distinctions between the Section 5(a)[3] docket and the Section 4(e)[4] dockets. The record was developed on a consolidated basis to obtain information respecting all of Phillips' jurisdictional natural gas operations. The evidence was submitted without particular regard as to whether it pertained to the general rate investigation or to the specific rate increase filings included within that investigation.

3. 52 Stat. 823 (1938), 15 U.S.C. § 717d(a) (1958). (Calif. Br., App. A, p. 3).

4. 52 Stat. 823 (1938), 15 U.S.C. § 717c(e) (1958). (Calif. Br., App. A, p. 2).

There was nothing unusual in consolidating the dockets[5] because Sections 5(a) and 4(e) are similar in purpose. Even though in different parts of the Natural Gas Act, both provisions are designed to achieve the broad purpose of consumer protection. For example, in a recent case this Court was not persuaded to make a distinction between interim order procedure in a Section 5(a) proceeding where no refunds were involved and the same procedure under Section 4(e) where refunds had been ordered. *Federal Power Commission v. Tennessee Gas Transmission Co.*, U. S. (1962). California believes that this Court was declining to draw hairline technical distinctions where an overriding public interest was involved.

It must be conceded that there are no differences between the objectives of each statute so far as consumer interests are concerned. While there are differences in language and procedural detail, these differences vanish after the initiation of proceedings. Hearings are conducted in like manner; presentations and examinations are made in similar fashion.

Sometimes it is difficult to determine which provision is the authority for a Commission proceeding. In *Shell Oil Co.*, Docket No. RI61-515, certain producers filed for increased rates pursuant to Section 4. Such increases became effective. Somewhat earlier the Commission had rejected similar increases proposed by another producer. *The Pure Oil Co.*, 25 FPC 383 (1961), affirmed *The Pure Oil Co. v. Federal Power Commission*, 299 F.2d 370 (1962). One of the questions in the *Shell* proceeding, instituted by an order to show cause, was whether the Commission should reject the producers' filings on the basis of its *Pure* decision. When the proceeding commenced, there was obviously a hearing under Section 4(e), yet as the proceeding developed it took the form of a Section 5(a) investigation. It was never determined, because it was unnecessary to do so, whether the Commission was acting

5. It has, in fact, been a common practice of the Commission to consolidate Section 5(a) and Section 4(e) proceedings for purposes of hearing and decision.

under Section 4(e), as purported, or whether the show cause order was in fact issued under Section 5(a). In short, the distinctions and differences between the two sections disappear in most, if not all, cases when hearings or litigation commence.

Section 5(a) and Section 4(e) being similar in purpose, decisions in the form of findings and orders should ensue under both provisions.

The Commission and Phillips attach no such requirement to Section 5(a). They would have Section 5(a) interpreted so as to limit its scope to the fixing of future rates when existing rates are found to be unjust and unreasonable. (Com'n Br., p. 31; Phillips Br., pp. 29-30). California, of course, does not dispute the proposition that a finding of unjust and unreasonable is a condition precedent to the setting of future rates under the statute. But this proposition is not identical to the interpretation urged by the respondents.

Section 5(a) provides:

> "Whenever the Commission, after a hearing had upon its own motion or upon complaint by any State, municipality, State Commission, or gas distributing company, shall find that any rate * * * is unjust, unreasonable * * * the Commission shall determine the just and reasonable rate * * * to be thereafter observed and in force, and shall fix the same by order * * *."

California finds two facets to this provision. First, the Commission on its own motion, or upon complaint, investigates the existing rates of natural gas companies to determine their lawfulness; second, the Commission sets rates for the future if the investigated rates are found to be unjust and unreasonable. There is no dispute respecting the latter statement. It is to the former that the Commission and Phillips object.

Assuming the validity of this objection, the narrow interpretation would mean that the Commission reserves the right to terminate a Section 5(a) proceeding, as it did this proceeding, at any time and for any reason. For example, a State being of the opinion

that the existing rates of a natural gas company do not meet the standard of just and reasonable, may institute a complaint proceeding under the statute. The Commission then conducts a hearing and finally issues an order of termination supported by any number of reasons, but not based on a finding that the rates are just and reasonable. By this order of termination the protested rates are allowed nevertheless to remain in effect *as if* just and reasonable, but without a finding to that effect. If the State objects to the termination, the Commission's response would be that Section 5(a) compels it to act only when there is a finding of unjust and unreasonable rates and, since no such finding was made, termination of the proceeding was in order.

California's position is that such a situation initially calls for a finding relative to the justness and reasonableness of the protested rates. If these rates are just and reasonable, the complaint proceeding must be concluded with such a finding; if the same rates are unjust and unreasonable, a finding to that effect must be made, but with the Commission further obligated to fix rates for the future. Whichever the situation, the Commission must make a finding.

In this case the Commission argues that it was not obligated to do anything under Section 5(a) because no finding that Phillips' rates were unjust and unreasonable was made. The Commission is tying its own hands. Once instituted, this proceeding became no different from a Section 4(e) matter as far as the reaching of a result was concerned. Regardless of the section, the result reached must protect the consumers of natural gas. And under the Natural Gas Act consumers are not protected by orders of termination without findings relative to the rates at issue.

Somewhat indicative of the Commission's unusual approach and concept of its own requirements is its recent treatment of an omission to make a finding of justness and reasonableness in one of its opinions. In *El Paso Natural Gas Co.*, Docket Nos. G-4769, *et al.*, Opinion No. 366, issued October 19, 1962, the Commission, in deciding a rate proceeding covering a span of eight years,

omitted a precise statutory finding as to the justness and reasonableness of El Paso's past and existing rates. El Paso raised this issue in its petition for rehearing. In the order denying petitions for rehearing, issued December 7, 1962, the Commission corrected this deficiency in its findings: "[T]he proposed increased rates filed by El Paso, are excessive and unreasonable to the extent they reflect amounts of return and related taxes in excess of those allowed in our opinion and order No. 366, and should to that extent be disallowed at this time." This, at the very least, represents a current recognition of the necessity for findings consistent with the practice under the Natural Gas Act until the startling omission found in the instant *Phillips* case.

These questions logically present themselves: Would the Commission have committed error in the *El Paso* case by omitting the basic findings? Could the Commission have directed El Paso to make significant refunds absent these basic findings? If the Commission can be excused from its statutory duty as to findings in the instant case, can it not then be argued that the dispensation of such basic findings would excuse other findings as to other issues. Such a broad result has already been condemned by this Court. *Colorado-Wyoming Gas Co. v. Federal Power Commission*, 324 U.S. 626, 631, 634 (1945).

If it is the Commission's view that findings are mandatory in a Section 4(e) proceeding, then the Commission should offer some explanation for its contrary position respecting Section 5(a). Since both provisions are designed to accomplish the same purpose—consumer protection—specific findings should be required in both.

III.

The Reasons Advanced for the Termination of the Proceeding Are Without Merit

The Commission argues that there was no abuse of discretion in terminating the Section 5(a) docket. The gravamen is that the record was unreliable because it was based on the unworkable premise that Phillips' costs should be the sole determinant of price

and because it was seriously outdated, thus unsuitable for making a decision. (Com'n Br., pp. 30-48). While California believes the Commission's views on the cost of service are unsupportable (Calif. Br., pp. 42-44), the Commission's argument respecting the staleness of the record will be considered further.

California is asking only that the Section 5(a) investigation be concluded. The fact that it took almost three years from the end of the hearings to the issuance of the Commission's order of termination is not by itself an excuse for termination. If the record was stale, it should have been reopened so as to permit a decision on the lawfulness of Phillips' existing rates. The relief California is seeking is much different from a request to reopen a record after a decision has been made on the record.

Even if the Commission were correct in so viewing the record, it was error to allow the rates to be treated as if just and reasonable on that record. The proper action would have been to correct the record, not to terminate the proceeding. The parties to the proceeding were entitled to a decision on the issues they had litigated.

In *Minneapolis Gas Co. v. Federal Power Commission*, 294 F.2d 212, 214-215 (D.C. Cir. 1961), a similar attempt by the Commission to terminate a proceeding was rejected:

> "In the case at bar the Commission entered upon a hearing concerning the lawfulness of proposed rates under [Section 4(e)] of the [Natural Gas Act]. That hearing was actually conducted and concluded. All parties announced that they had no further evidence to present. The Examiner made findings of fact, reached conclusions, and rendered an initial decision. Under the Administrative Procedure Act [Sec. 8(a)] the initial decision was a final decision unless upon exceptions the Commission itself concluded otherwise. The Commission received and heard arguments on exceptions. Thereupon the Commission terminated the proceedings. It did not render a decision. * * *
>
> "We think the Commission cannot terminate a proceeding after it has actually conducted a hearing to the point of receiving an Examiner's initial decision, *without rendering a*

decision upon the issue presented, which is the lawfulness of the proposed rates." (Emphasis supplied)

The Commission's action in both *Minneapolis Gas* and the instant proceeding resulted in the termination of proceedings without a finding on the issue presented—the justness and reasonableness of rates. In both cases extensive hearings were conducted, briefs were ordered, initial decisions were issued, oral arguments were heard and, in each instance, the Commission terminated without a finding. In *Minneapolis Gas* the court found such action unlawful. The same judgment should have been made in the instant proceeding.

The Commission contends that the termination of the Section 4(e) dockets also was appropriate. The only issue here, in the Commission's view, was whether refunds should be ordered for the periods during which the rates were in effect. (Com'n Br., pp. 48-53). California's position is that no conclusion concerning refunds is valid, or even possible, without a prior conclusion respecting the justness and reasonableness of the rates. (Calif. Br., pp. 29-34).

Section 4(e) allows for hearings "concerning the lawfulness" of rates. According to Section 4(a),[6] lawful rates are just and reasonable rates. Section 4(e), then, is designed to *test* the lawfulness of rates. Its primary purpose is not, as the Commission suggests, to decide whether refunds should be ordered for "locked-in" periods.[7]

The provision for refunds is merely a means of accounting for amounts collected while the issue of justness and reasonableness is

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6. 52 Stat. 822 (1938), 15 U.S.C. § 717c(a) (1958). (Calif. Br. App. A, p. 1).

7. The "locked-in" period is an anomaly of the Natural Gas Act. It was the intention of Section 4(e) that a rate proceeding be handled "as speedily as possible." However, through administrative lag a rate increase filing is allowed to be superseded indefinitely by subsequent filings, thus creating the locked-in periods. When the Commission finally attempts to determine the lawfulness of the original filing, the significance of the rates contained therein pales in the light of the subsequent filings.

pending before the Commission. The primary purpose of Section 4(e) is to consider the lawfulness of filed rates. Until a decision on the lawfulness of the rates is made, the question of refunds is not before the Commission.

Nor does a conclusion that no refunds are required follow from the fact that Phillips' costs exceeded revenues in a particular test year. In *Hunt Oil Co.*, Docket Nos. G-9065, *et al.*, Opinion No. 365, issued October 17, 1962, a consolidated Sections 5(a) and 4(e) proceeding, the Commission remanded the case to its examiner and said: "Our examination of the record in this case convinces us that increased rates for specific sales cannot always be found to be just and reasonable solely on the basis of a comparison of individual company-wide costs with that company's revenues in a test year." (Mimeo, p. 5).

The Commission's termination of the instant consolidated proceeding seriously affects California. Both sections are imbued with the public interest declared by Congress and often expressed by this Court. California intervened in the instant case as a representative of that public interest. The Commission's act of termination, without determination of the issue of the lawfulness of rates, deprived California of its right to a decision and the public of its interest in the enforcement of the Natural Gas Act according to the dictates of Congress.

IV.

The Validity of Spiral Escalation Clauses Is an Issue Properly Before This Court

The Commission's order instituting this proceeding set down for resolution the issue of the validity of Phillips' spiral escalation clauses. (R. 32). California has preserved this issue in its exceptions (R. 232-233), its petition for rehearing (R. 367-370), and in the Court of Appeals (R. 426-427). The Commission and Phillips urge that the issue is not reviewable because no "final orders" have been entered in Docket Nos. G-11217 and G-10883

wherein Phillips' rate increase filings were predicated upon the alleged activation of Spiral escalation clauses. (Comm. Br., pp. 54-55; Phillips Br., pp. 44-45). This position ignores the fact that the Commission left open each docket for a final determination of the *extent* of the increase only and for "no other matter." (R. 329). Once the rates of the pipeline companies buying from Phillips are determined in other proceedings, the only issue remaining in these dockets is the proportionate *amount* of the increase Phillips is entitled to under its sales contracts. California is concerned here with the contractual basis for the increase. The Commission finally determined California's legal rights on this contract issue in this proceeding, and if review is denied on the issue California will have been deprived of an opportunity to be heard.

Review of administrative proceedings is not premised on the issuance of "final orders." In *Atlantic Seaboard Corp. v. Federal Power Commission*, 201 F.2d 568, 572 (4th Cir. 1953), the court said:

> "The commission argues that the order which we are asked to review is not a definitive or final order of the commission; but our power to review is not limited to final orders. Section 19(b) of the Natural Gas Act gives us power to review 'an order' of the commission upon the petition of a party aggrieved. We should not, of course, exercise the power to review mere preliminary or procedural orders or *orders which do not finally determine rights of the parties*." (Emphasis supplied).

Significantly, this Court, in *Columbia Broadcasting System, Inc. v. United States*, 316 U.S. 407, 425 (1942), said:

> "The ultimate test of reviewability is not to be found in an overrefined technique, but in the need of the review to protect from the irreparable injury threatened in the exceptional case by *administrative rulings which attach legal consequences to action taken in advance of other hearings and adjudications that may follow*, the results of which the regulations purport to control." (Emphasis supplied).

To refuse to review Phillips' spiral escalation clauses in this proceeding would indeed result in irreparable injury to the millions of California ratepayers whose rates would depend then on automatic and arbitrary adjustments and not on regulatory standards.

There was, of course, a "final order" in Docket No. G-10795. However, the Commission also would have review denied here. (Comm. Br., pp. 56-57). The importance of this docket is that the Commission therein did give legal effect to this filing even though based on a spiral escalation clause. If it so acted with one such clause, it follows that it acted in the same manner with the other clauses. While California has a special interest in the escalation clauses in the Phillips-El Paso contracts for gas which ultimately reaches California, nevertheless the action this Court takes relating to that docket would necessarily apply to the others. There is inconsistency in the Commission urging denial of review in two dockets where it says no "final orders" were issued and at the same time raising the identical contention in a docket where admittedly a "final order" was made.

Phillips further argues that California has not defined the public policy which spiral escalation clauses violate. (Phillips Br., p. 47). The Commission itself has defined that public policy and the authorities have been cited. (Calif. Br., pp. 58-60). These clauses are objectionable because they assume that an increase in the resale rates of a pipeline company should have some retroactive effect on the rates of the producer who has been supplying that pipeline company. Actually, an increase in the pipeline company's rates has no economic bearing on the factors which make for a just and reasonable producer rate. Once a sale is made, the price later charged by the buyer to his customer is immaterial to the seller. Moreover, by the use of spiral escalation clauses, a producer with highly profitable rates nevertheless is entitled to file for even higher rates through the triggering of such clauses. Where prices are so indefinitely established by contract, the Commission has a burdensome task of reviewing numerous rate filings which do not purport to be justified on any basis other than the

occurrence of fortuitous events, and consumers have an unhappy obligation of paying rates deliberately inflated by private contract.

The Commission and Phillips rely on *Phillips Petroleum Co. v. Federal Power Commission*, 227 F. 2d 470 (10th Cir. 1955), cert denied 350 U.S. 1005 (1956), and *Kerr-McGee Oil Industries, Inc. v. Federal Power Commission*, 260 F.2d 602 (10th Cir. 1958), to support the legality of spiral escalation clauses. (Comm. Br., p. 60; Phillips Br., p. 45). Certainly in both cases contracts containing such provisions were reviewed. However, the cases held only that the Commission could not treat as a new rate a rate already in effect on June 7, 1954 (the date when producers were brought under regulation). The issue of the validity of the clauses on public policy grounds was not before the court. Ironically, the Commission and Phillips contend that the issue is not present in the instant case yet, in the same breath, in urging this Court to uphold these clauses, they rely on cases where the issue was not even litigated.

Texas Gas Transmission Corp. v. Shell Oil Co., 363 U.S. 263 (1960), and *Warren Petroleum Corp. v. Federal Power Commission*, 282 F.2d 312 (10th Cir. 1960), likewise are not cases supporting indefinite escalation clauses but cases concerned with the question of whether the Commission's construction of the clauses was a matter within its expert knowledge. In *Atlantic Refining Co. v. Public Service Commission of the State of New York*, 360 U.S. 378 (1959), this Court did no more than point out, at page 391, that a proposed initial contract price might not be in keeping with the public interest because "its approval might result in a triggering of general price rises or an increase in the applicant's existing rates by reason of 'favored nation' clauses or otherwise * * *." This statement seems to support California's position on public policy rather than to aid the Commission and Phillips' defense of the clauses.

Remaining is the Commission's argument that rejection of filings based on the clauses might deprive Phillips and other

producers of contract rights. (Comm. Br., pp. 61-63). The argument is that Phillips may have accepted less favorable terms at the time the contracts were executed in return for the inclusion of the escalation clauses, and to strike these "bargained-for" provisions would be a "harsh" decision. While there is no record basis for the argument and Phillips itself does not raise it, California will add that any question as to the separability of the clauses from the contracts was answered when Phillips agreed to eliminate them in the future. (R. 327).

The Commission relies on *Southwestern Sugar & Molasses Co., Inc. v. River Terminals Corp.*, 360 U.S. 411 (1959), to support its argument. The *Southwestern Sugar* case is clearly distinguishable on facts and law from the instant proceeding. *Southwestern Sugar* did not concern administrative action but arose from a libel action by a shipper against a carrier for loss of uninsured cargo through negligence. The question was whether a shipper could recover damages from a carrier protected by an exculpatory clause. In the present case, the question is whether a particular contract clause is void in a regulatory setting. This case, then, involves regulatory action and not a question of damages before a court of law. Moreover, there is no similarity between the exculpatory clause which was not declared void in the *Southwestern Sugar* case and the spiral escalation clauses involved in this proceeding. The exculpatory clause operates to reduce rates to the benefit of the shipper and, as this Court recognized at page 418 of that decision, if the carrier were able to exact high rates and limit its liability at the same time the circumstances might be different. Spiral escalation clauses, on the other hand, operate to increase rates by allowing producers to file for increases at indefinite times and under indefinite conditions.

The implausibility of the Commission's position is evident from the following argument in its brief:

> "In the first place, if the Commission were to void all spiral escalation clauses, whenever executed (or if this Court, by its decision here, were to do so), it might well be inundated by rate filings of producers claiming, whether validly

> or otherwise, that the contracts were no longer in force and therefore no longer restrained them from filing for higher rates." (Comm. Br., p. 61).

This argument seems to assume a right of producers to file for rate increases unilaterally without contract support. There is a requirement that any rate increase application must be based on an agreement between the seller and buyer. *United Gas Pipe Line Co. v. Mobile Gas Service Corp.*, 350 U.S. 332, 340 (1956). If the clauses are stricken the contract price might be that called for by the contract in the absence of the activation of the escalation clause, or the price on June 7, 1954. There can be no unrestrained filings as the Commission suggests.

Spiral escalation clauses were declared prospectively void less than a year after the Commission's opinion in this case. The Commission used this proceeding as a vehicle for rejecting cost of service and for promulgating the Policy Statement but, for some unexplained reason, refused to use it to declare spiral escalation clauses void for regulatory purposes.

V.

The Primary Question Presented Is Whether or Not the Commission Has Implemented This Court's Mandate to Regulate Producers of Natural Gas

The Court below characterized this case as one involving "major problems of general application" and posing "complicated procedural difficulties." (R. 414). This statement is recognition that not only is the regulation of a single natural gas producer involved, but also the regulation of producers generally. The instant case presents an opportunity to this Court, having ordered previously the regulation of producers under the Natural Gas Act, to decide whether or not the Commission is implementing that order.

The crux of California's complaint is that the Commission has not followed this Court's mandate. It is obvious that the regulation of pipeline prices was of dubious value when the

prices paid by the pipeline companies to the producers were unregulated. Yet the opinion of the Commission and the decision of the court below have caused such uncertainty in this producer price regulation as to raise the serious issue of whether this Court's mandate is being followed.

As producer regulation now stands, the Commission fluctuates between the Policy Statement, with the cost of service method rejected, and recent expressions seeming to favor cost of service. (Calif. Br., pp. 40-42).

This running from method to method is based upon a Commission concept of license to do so. Since the cost method is the antithesis of the Policy Statement method, it is apparent that one must be inconsistent with the Natural Gas Act, and in conflict with the mandate for effective producer regulation. The danger of this proceeding rests in the facts that the Commission assumes the right to regulate upon either basis, when in fact the Natural Gas Act is designed for cost regulation (Calif. Br., pp. 44-45) and the case law to date clearly indicates that costs are essential ingredients to producer regulation. (Calif. Br., pp. 35-42).

Phillips, however, would have this Court's review restricted to a few technical points. (Phillips Br., pp. 19-24). The analysis of the Court of Appeals is to the contrary, and the Commission itself does not urge such a restriction.

Phillips ignores the fact that this is the case in which the Commission was directed in 1954 to proceed to regulate independent producers. This Court is reviewing then the Commission's opinion in terms of compliance or noncompliance with its mandate. A complete review by this Court is not to be frustrated by a provincial approach which ignores the interest of the nation's consumers, particularly where that interest is charged with being subverted. This Court as a matter of law possesses jurisdiction for complete review upon the issue inherent in this case as to whether or not its directive is being followed.

The narrow review which only Phillips urges, and for the first time in this Court, can be traced to a misunderstanding of California's petition for rehearing of the Commission's opinion. In its

petition California did not think it proper to take a position on the validity of the proposed area rate program, and the Commission was advised that any arguments would be reserved for those proceedings wherein area rates were to be developed. (R. 363-364). However, California sought rehearing on grounds which included the contention that the Commission's general investigation of all of Phillips' rates was unlawfully terminated. Without question, the motivating factor behind this termination was the Commission's assertion that it could abandon presently lawful procedures and regulate on a temporary basis by administrative fiat until new procedures were lawfully constituted.

The issues which Phillips now wishes to have deleted were considered at length by the Court of Appeals and formed an integral part of the decision below. The matters raised by California are properly before this Court also by way of this Court's authority to review that decision.

Even if California had not filed a petition for rehearing, this Court might still review this matter. In *United States v. Abilene & S.R. Co.*, 265 U.S. 274 (1924), the Government appealed from a decree of a Federal District Court wherein the court refused to dismiss a suit to enjoin an order of the Interstate Commerce Commission even though no rehearing of the agency's order had been sought. This Court said, at page 282:

> "Despite the failure to apply for a rehearing, the court had jurisdiction to entertain this suit. * * * Whether it should have denied relief until all possible administrative remedies had been exhausted was a matter which called for the exercise of its judicial discretion. We cannot say that, in denying the motion to dismiss, the discretion was abused."

All issues raised by California are not only before this Court, but also they are deserving of this Court's complete review. This proceeding is no mere controversy as encountered in the traditional regulatory case. This Court looks, as it must, at the broad implications which lie beyond the legal assertions.

CONCLUSION

For each and all of the reasons stated herein as well as for the reasons stated in its Brief for Petitioners, California urges that the opinion of the Commission, and the decision of the Court of Appeals affirming the Commission, be set aside as unlawful, and that the proceeding be remanded to the Commission with directions to regulate the rates of Phillips, and of all other independent producers, in accordance with the Natural Gas Act and the original mandate of this Court.

Respectfully submitted,

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